IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PETITIONER

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OPINIONS BELOW

The opinions of the United States Tax Court, 64 T. C. 154 (1975), and of the United States Court of Appeals for the Seventh Circuit, 563 F. 2d 861 (1977), are respectively reproduced in the Appendix to the Petition at A-6 and A-34.

JURISDICTION

The judgment of the Court of Appeals was entered on September 29, 1977 (Pet. A-33). A Petition for Certiorari was filed in this Court on December 27, 1977, asserting jurisdiction pursuant to 28 U. S. C. § 1254(1). This Court granted the Petition on March 6, 1978 (A267).

STATUTE AND REGULATIONS INVOLVED

The relevant sections of the Internal Revenue Code for the period in question (which remain substantively unchanged) are:

Section 446, 26 U. S. C. § 446, providing in part:

"General Rule for Methods of Accounting.

"(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"* * *"

Section 471, 26 U. S. C. § 471:

"General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Section 166, 26 U. S. C. § 166, providing in part:

"Bad Debts.

"(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

"* * *

"(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

"* * *"

Treasury Regulations §§ 1.446-1(a), 1.471-2, 1.471-4, and 1.166-4, in effect for the years at issue, are set out in the Appendix to the Petition (Pet. A-1 through A-5).

QUESTIONS PRESENTED

1. Did the Court of Appeals err in holding that the Commissioner did not abuse his discretion by disallowing Thor's writedown of "excess goods"—primarily replacement parts held in quantities exceeding the number which Thor reasonably determined would be sold, and which eventually would be scrapped—from cost to net realizable value (*i.e.*, scrap value), where such writedown:

(a) is, consistent with § 446 of the Code, in accordance with generally accepted accounting principles;

(b) fulfills the requirement of "best accounting practice" in Thor's trade or business within the meaning of § 471 of the Code;

(c) clearly reflected Thor's income for financial accounting purposes; and

(d) is not inconsistent with the applicable Treasury Regulations, but in fact is authorized by a construction of them that effectuates the intention of § 446 and § 471?

2. Did the Court of Appeals err in holding that the Commissioner did not abuse his discretion by requiring that Thor's 1965 addition to its reserve for bad debts be calculated solely by a mechanical 6-year average of Thor's past bad debt charge-offs, which, contrary to the Treasury Regulations, ignored current facts and circumstances affecting the collectibility of Thor's accounts receivable at the close of that taxable year?

STATEMENT OF THE CASE

The relevant facts are uncontroverted and are well-summarized in the Tax Court's Findings of Fact (Pet. A-8 through A-17).

Inventory Issue

In determining Thor's taxable income for 1964, the Commissioner disallowed $926,952 of Thor's "cost-of-goods-sold," which was the amount by which Thor had written down its closing inventory for excess and unsalable goods.

The "Explanation of Adjustments" in the Statutory Notice of Deficiency states (A3):

> "The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954."*

During 1964 and for all pertinent years before and after that year, Thor valued its inventory by the method of accounting known as the "lower-of-cost-or-market," applied on a first-in, first-out (FIFO) sequence (Pet. A-9).

Thor manufactures and sells hand-held power tools, parts and accessories for commercial and household uses and commercial rubber products. A typical Thor tool contains from 50 to 200 individual parts, each of which Thor stocks to meet expected customer demand for replacement parts. Because it is

* Both the $1,079,069 and the reference to § 162 were in error. The parties agree and the Tax Court found that the correct amount at issue is $926,952 (Pet. A-13).

The Tax Court held that cost-of-goods-sold is not a deduction subject to the rules of § 162 or any other section of the Code, but is a constitutionally required reduction from gross receipts to determine gross income (Pet. A-17).

practically impossible to accurately predict future demand for individual parts at the time they are manufactured, Thor produces liberal quantities of each part to avoid additional production runs to replenish the supply of a part that has been exhausted. Such reruns require uneconomical tooling and set-up costs that substantially increase the cost of the part and cause delays in supplying it to customers (A55).

Thor attempts to maintain a complete inventory of replacement parts for each tool model so long as a significant population of that model remains in use, which may be for many years after Thor has discontinued producing it. Thor does not scrap its supply of a particular part until it is reasonably sure that there will be little or no future customer demand for that part (A54).

The maintenance of ample inventories of parts and accessories is vital to serving the needs of Thor's customers. In 1965, over 30% of Thor's total sales were of parts and accessories (A54).

In 1960, Thor initiated a procedure for reducing the inventory value of replacement parts and accessories for tool models it no longer produced by amortizing their cost over the 10-year period following the discontinuance of the model's production.* For the years 1960 through 1963 such writedowns, totalling $152,117, were not questioned by the Commissioner on audit. During 1964 this procedure resulted in an additional $22,090 writedown (Pet. A-9).

In late 1964, Thor's new management, which had just been installed by agreement with Thor's principal shareholder,** concluded that Thor's inventory was greatly overvalued, causing it

* The reduction in inventory value was effected through an inventory contra account entitled "Reserve for Inventory Valuation" to which the writedowns were credited. This credit reduced closing inventory for the year, thereby increasing cost-of-goods-sold and reducing income for that year by an equal amount (Pet. A-9–A-10).

** For background, see the Tax Court's Findings (Pet. A-10).

to undertake a careful and detailed analysis of closing inventory incident to closing the books and preparing the financial statements as of December 31, 1964. This resulted in writeoffs and writedowns totalling $3,000,000, including $1,603,000 for obsolete inventory, and $245,000 for three products held in quantities estimated to be in excess of what could be sold (A52–A56).

There remained some 44,000 different items in inventory at Thor's factories and branches, many of which were held in quantities substantially in excess of any reasonably foreseeable demand, as follows:

	Number of Different Items
Raw Materials	4,297
Work-in-Process	1,781
Finished Parts & Accessories	33,670
Finished Products	4,344
Total Number of Inventory Items	44,092

Because of the great number of these items and the relatively low value of each of them, it was impractical within realistic cost or time limits, to estimate on an item-by-item basis how many units of each item would be sold or used in manufacturing finished goods. Instead, based on long manufacturing experience and a careful review of the situation, management utilized two procedures to ascertain the extent by which inventory exceeded anticipated customer demand and to accurately value that excess (Pet. A-10–A-11).

Under the primary procedure, expected demand for each item was forecast on the basis of actual 1964 usage—actual sales for tools, service parts and accessories, and actual production for raw materials, work-in-process and production parts. Using this data, the value of the inventory was reduced as follows:

(i) that quantity of each item not in excess of 12 months anticipated demand was not written down;

(ii) that quantity of each item in excess of 12 months, but not in excess of 18 months anticipated demand, was written down 50% ;

(iii) that quantity of each item in excess of 18 months, but not in excess of 24 months anticipated demand, was written down 75% ; and

(iv) that quantity of each item in excess of 24 months anticipated demand was written off.

The mechanics of this procedure are well-illustrated by the following example from the Tax Court's Findings of Fact (Pet. A-11–A-12). It assumes that 100 units each of five different items were on hand at December 31, 1964, and that their 1964 usage ranged from 20 to 100 units.

Item	Units on Hand at 12/31/64	Units Sold or Used in 1964	Anticipated Demand 0-12 Months	13-18 Months	19-24 Months	+24 Months	% of Write-down
A	100	20	20	10	10	60	
			0%	50%	75%	100%	
			0	5	7.5	60	= 72.5%
B	100	40	40	20	20	20	
			0%	50%	75%	100%	
			0	10	15	20	= 45.0%
C	100	60	60	30	10	0	
			0%	50%	75%	100%	
			0	15	7.5	0	= 22.5%
D	100	80	80	20	0	0	
			0%	50%	75%	100%	
			0	10	0	0	= 10.0%
E	100	100	100	0	0	0	
			0%	50%	75%	100%	
			0	0	0	0	= 0.0%

Application of Thor's item-by-item procedure to each of the five items results in writedowns from 72.5% for item A to none for item E, even though there were 100 units of each item in closing inventory. By this procedure Thor did *not* simply eliminate a fixed percentage of its inventory. Instead, as the example

shows, *actual usage* during 1964 for each of the 44,000 individual items was utilized on an item-by-item basis to estimate how many units of that item eventually would be sold or used in production. That quantity *of each item* determined to be salable or usable was carried at cost (or if lower, at current replacement cost), and the quantity deemed excess and unsalable was written down to its net realizable value (*i.e.*, scrap value).

The procedure is self-correcting in that any increase in sales of a particular item from one year to the next automatically decreases the amount of that item treated as excess at the end of the second year; conversely any decrease in sales increases the writedown for excess inventory in the latter year.*

A supplementary procedure was used (in addition to the primary procedure) at two plants where the 1964 usage data was insufficient to fully forecast future usage. This procedure consisted of percentage writedowns for 9 categories of items (Pet. A-12; Ex. 13, A38, A209):

Percentage Writedown	Number of Categories	Description	Amount of Writedown
5%	2	Tool parts and motor parts at LaGrange Park tool plant	$ 26,341
10%	6	Raw materials, manuals and name plates, and work-in-process at LaGrange Park plant; raw materials, work-in-process and finished goods at Cincinnati rubber plant	99,954
50%	1	Hardware items at LaGrange Park plant	34,537
			$160,832

* To illustrate, assume that the sales of Item A increased from 20 units in 1964 to 40 in 1965. At the end of 1965 there would be 60 units (100 minus 40) actually in inventory. Based on the 40 sold during 1965, the 60 units represent 18 months' demand —40 units for the first 12 months and 20 units for the next 6 months. Under the procedure, 50% of the 20 units, or 10 of them, would be written down, leaving a balance of 50 units. The writedown in the previous year totalled 72.5 units, leaving a balance of 27.5. This requires the *value* of 22.5 units to be *restored* to inventory at the end of 1965 to reach the required balance of 50 units. This restoration increases closing inventory, reduces the cost-of-goods-sold, and increases taxable income by the same amount.

The same correction works in reverse where the demand for the succeeding year has been overestimated.

The 50% writedown was required because numerous hardware items were stored without identifying part numbers, making it impractical to use much of this hardware (A140).

Thor's total writedown for excess inventory for 1964 was:

10-year amortization of parts for discontinued tools	$ 22,090
Primary writedown procedure	744,030
Supplementary writedowns	160,832
	$926,952

The entire writedown was disallowed by the Commissioner.

Of the total writedown of $927,000, $847,000 appertained to Thor's Tool Division; of this amount, 78% was specifically identified as having been scrapped from 1965 through 1971 (Ex. 17, A38, A218).*

Thor did not attempt to sell the excess finished parts and accessories, which for the years 1964 through 1971 represented from 70% to 82% of the excess inventory writedown, at reduced prices, because the market for them is confined to owners of the related tools who purchase replacement parts when and if needed, and will not buy unneeded parts merely because of price reductions. It tried to sell excess quantities of work-in-process (consisting of partially completed parts and tools) and of raw materials, but learned that these were salable only as scrap. Some excess finished tools were sold at reduced prices, but most were so highly specialized that price reductions did not stimulate additional sales (Pet. A-14).

Mr. Arthur R. Collins, who became President of Thor in late 1964, testified that he personally directed the inventory valuation procedures Thor used in preparing its 1964 financial

* Actual scrappings were significantly higher than the amounts reported. Thor's sales branches did not record their scrapping (Pet. A-14—A-15), and the accounting experts testified that a sizable portion of goods actually scrapped by a manufacturer such as Thor are not recorded as such, but show up as unidentified inventory shortages (A111—A112, A138, A161, and A179).

statements, and that the principal judgments underlying the excess inventory writedowns were based on his then more than 20 years' experience in the manufacturing industry (A51, A53–A58). He explained that the primary writedown formula actually adopted was a pragmatic compromise between writing off all inventory in excess of one year's supply, which probably would have been too large a writeoff in Thor's situation, and writing off only inventory in excess of two years' supply, which would have been insufficient because of potential technological and market changes (A57–A58). Mr. Collins testified that the percentages used in the supplementary procedure were selected for each category on the basis of judgment, explaining that "[a]dmittedly, this is not a precise way of doing it, but we felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value" (A67). He pointed out that in 1971, these supplementary procedures were used to *decrease* the writedown under the primary procedure by $97,373, thereby increasing taxable income that year by the same amount (A64–65; Ex. 27, Tr. 121, A227). He further testified without contradiction that the sole purpose of all the inventory procedures was to reach an accurate inventory valuation at the end of 1964, and that income tax consequences were not considered at all (A61).

In 1970, Thor engaged Arthur Andersen & Co. as its independent auditors. Wilson J. Besant, C. P. A., the partner-in-charge of Arthur Andersen's initial audit, testified that his firm performed special "first-time-through" procedures, including a detailed review of Thor's excess inventory valuation procedures. This special review confirmed that Thor's procedures were in accord with generally accepted accounting principles and were reasonable (A84–A89). Based on his review of the data from 1962 through 1971, including the declining trends of Thor's sales, domestic profits and gross profit percentage, and the extent of the inventory scrapping, Mr. Besant testified that Thor's writedown of excess inventory in 1964 was "not exces-

sive", and in fact may have been insufficient (Ex. 19, A88, A219; A90–A92).

This testimony of Thor's chief executive officer and of its independent certified public accountants was corroborated without contradiction by five expert witnesses, all of whom were leaders in the public accounting profession.* Each of them testified that at the end of 1964 Thor had excess inventory which it was obligated to write down in order to comply with generally accepted accounting principles (A53–A54, A108,

* The preeminent practicing accountants who testified on behalf of Thor were:

The late Robert M. Trueblood, C. P. A. since 1937, and at the time of trial Chairman of the Board of Touche Ross & Co.; past president of the American Institute of Certified Public Accountants ("AICPA"); then Chairman of the AICPA 9-member Commission on the Objectives of Accounting; former member of the AICPA Long-Range Objectives Committee and Accounting Principles Board, which for many years was the accounting profession's primary authority on matters of accounting principles and practice (A96–A97).

Newman T. Halvorson, C. P. A. since 1930, and at the time of trial the national partner-in-charge of Technical Auditing and Accounting Services for Ernst & Ernst; member of the Accounting Principles Board (A152–A154).

Bertrand J. Belda, C. P. A. since 1931, and at the time of trial the national partner-in-charge of Management Consulting Services for Ernst & Ernst, specializing in management accounting, including matters of inventory valuation. He participated in drafting the comments which the Division of Federal Taxation of the AICPA submitted in 1972 to the Internal Revenue Service, at its request, on the proposed revisions of the Regulations governing the valuation of inventories (Ex. 29, A151, A223), referred to at p. 64 *infra* (A126–A127, A147–A151).

Frank T. Weston, C. P. A. since 1939, at the time of trial Chairman of the Committee of Accounting and Auditing Standards of Arthur Young & Co.; member of the Accounting Principles Board and of the 9-member Commission on the Objectives of Accounting (A186–A188).

Howard B. Burris, C. P. A. since 1950, and at the time of trial a partner of S. D. Leidesdorf & Co., member of the Committees on Auditing Procedure and on Accounting Principles of that firm; member of the AICPA Committee on Auditing Procedure (A172–A173).

A137, A158, A176, A195). After reviewing the facts in this case—including the causes of the writedown for excess inventory, the nature of Thor's business, its history of declining sales and declining gross and net profit margins, and the extent of its scrap dispositions—each expert witness concluded that *both procedures* actually employed by Thor were in accord with generally accepted accounting principles, and would have been approved by his accounting firm (*primary writedown procedure:* A109–A113, A133–A139, A159–A161, A176–A180, A195–A196; *supplementary procedure:* A113, A139–A140, A162, A180–A181, A196–A198). Each testified that if his firm had been Thor's independent auditors at the end of 1964, he would have insisted that Thor write down any excess inventory to net realizable value, and if Thor had refused to do so, his firm would have been unable to give an unqualified opinion certifying Thor's financial statements (income statement and balance sheet) for that year (A114, A133, A158, A176, A195).

Consistent with this testimony, the Tax Court found as facts that (Pet. A-15):

> "Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. *Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items.* If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, *and in particular the procedures it used for eliminating the cost of excess stock,* were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in

issue at its estimate of current net realizable value." (Emphasis added.)

In its opinion, the Court stated (Pet. A-19–A-20):

"Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case. A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was *required* in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that *the write-down of inventory was in accordance with generally accepted accounting principles and within the term, 'best accounting practice,'* as that term is used in section 471 of the Code and the regulations promulgated under that section." (Emphasis added.)

Notwithstanding its factual findings, the Tax Court held that the Commissioner had not abused his discretion in determining that Thor's inventory writedown procedures did not clearly reflect its income. The Court's conclusion seems to rest on three propositions:

(i) that even though a taxpayer's inventory valuation procedures conform to generally accepted accounting principles and constitute the best accounting practice in the taxpayer's trade or business, the Commissioner has discretion to determine that such procedures do not clearly reflect the taxpayer's income, which determination will be upheld unless it is "plainly arbitrary" (Pet. A-20–A-21);

(ii) that, as a matter of law, a taxpayer's inventory procedures clearly reflect income only if those procedures satisfy the requirements of the "more specific" sections of the Regulations (Pet. A-23); and

(iii) that Thor's procedures for valuing excess inventory "based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability . . . would, within some unknown limits, permit the taxpayer to determine

how much tax it wanted to pay for a given year" (Pet. A-26).

The trial judge's opinion was not reviewed by the full Tax Court.

The Court of Appeals affirmed for reasons similar in substance to those adopted by the Tax Court (Pet. A-41–A-46). It concluded that the Commissioner did not abuse his discretion in requiring that Thor physically scrap the excess inventory as a prerequisite to writing it down to net realizable value (Pet. A-46–A-47).

Bad Debt Issue

In 1965, the Commissioner disallowed $74,791 of Thor's addition to its reserve for bad debts, stating in the "Explanation of Adjustments" in the Statutory Notice of Deficiency (A3):

"The deduction of $136,150.36 for bad debts under reserve method is disallowed to the extent of $74,790.80 because it has not been established that any amount in excess of $61,359.56 constitutes a reasonable addition to the reserve under section 166 of the Internal Revenue Code of 1954."

Thor has calculated its bad debt expense by the reserve method, authorized by § 166(c) of the Code, for 1965 and all pertinent years before and after that year.

The Tax Court found that at the end of 1965, each of Thor's accounts receivable from unrelated persons in excess of $100 was individually reviewed by the credit clerk familiar with that account. If an account was judged to be wholly uncollectible, a 100% reserve was established for it. Several accounts totalling $183,986 were determined to be uncollectible. Other accounts were reserved against by 1% if they were not overdue by more than 29 days, and by 2% if they were overdue longer than that. Accounts of less than $100 were reserved against in the same ratio as those above $100. The determinations of the credit clerks were independently reviewed by Thor's credit manager,

then by its treasurer, and finally by its president (Pet. A-16, A-17).

These procedures established that a reserve of $228,946 was needed (Ex. 18, A38, A222):

	Percentage Applied	Amount of Reserve Needed	Percent of Total Reserve
Wholly Uncollectible	100%	$183,988	80.4%
Overdue more than 29 days	2	24,812	10.8
Not overdue by more than 29 days	1	19,403	8.5
Miscellaneous Adjustments	—	746	.3
Total		$228,948	100.0%

This required a $136,150 addition to the existing $92,798 balance of the reserve.

Notwithstanding these exacting procedures, the Commissioner determined that a reasonable addition to the reserve was limited by a 6-year average of Thor's past bad debt writeoffs, based on a formula first used in *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3. This historical average did not give any effect to Thor's judgment that at the end of 1965 some $184,000 of its receivables was wholly uncollectible, which constituted 80.4% of the total reserve Thor determined was necessary at the end of that year.

The Commissioner introduced no evidence at trial on this issue nor explained why or how Thor's bad debt evaluation was improper or inaccurate. He has not questioned the accuracy of Thor's determination that $184,000 of its receivables were uncollectible.

Four expert accounting witnesses testified that from the viewpoint of generally accepted accounting principles, the *Black*

Motor formula is deficient because it ignores present and future factors affecting the collectibility of accounts receivable (A120-A122, A144-A146, A167, A185-A186).

Notwithstanding its Findings (Pet. A-16–A-17), which recognized the detailed procedures Thor had utilized in calculating the 1965 addition to its reserve, the Tax Court held that the Commissioner had not abused his statutory discretion by limiting the reserve to the 6-year average of Thor's bad debt chargeoffs. The Court did not mention the uncollectible accounts, but simply concluded (Pet. A-32):

> "The burden on petitioner was to show that the Commissioner's determination was arbitrary, not that petitioner's method was better."

The Court of Appeals did not question the Tax Court's Findings. It held, seemingly as a matter of law, that the *Black Motor* formula was "reasonable" so that its use by the Commissioner did not constitute an abuse of his discretion, stating (Pet. A-48):

> ". . . In order to overturn the Commissioner's disallowance, therefore, the taxpayer must show that the Commissioner has abused his discretion. *Calavo, Inc.* v. *Commissioner*, 304 F.2d 650, 653-654 (9th Cir. 1962). This is a 'heavy burden.' . . . As we have stated before, the issue thus presented 'is whether the Commissioner's view is reasonable.' . . . If it is, the inquiry is ended. We agree with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable."

SUMMARY OF ARGUMENT

Inventory Issue

Section 446 of the Code sets forth in mandatory language the general rule that taxable income shall be computed according to the method of accounting by which the taxpayer keeps his books unless it "does not clearly reflect income". This requirement originated with the Revenue Act of 1918. Continuously since the issuance of Treasury Regulations 45 interpreting the 1918 Act, the Regulations have provided that if a taxpayer's method of accounting conforms to "approved standard methods of accounting" or to "generally accepted accounting principles," it "will ordinarily be regarded as clearly reflecting income". See Treas. Reg. § 1.446-1(a)(2). Almost identical language was used in the discussion of § 446 in the Reports of the House and the Senate accompanying the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).

Section 471 of the Code more particularly requires that inventory accounting shall conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income". This statutory language also emanates from the 1918 Act. Commencing with Regulations 45 interpreting that Act until 1973, the Regulations provided that an inventory that can be used under "the best accounting practice" in the taxpayer's trade or business "can, as a general rule, be regarded as clearly reflecting his income". Treas. Reg. § 1.471-2(b).

Whether the language of the Regulations under both § 446 and § 471 is deemed to set forth general rules or to create rebuttable presumptions, the effect is the same. It has been in both Regulations for more than a half-century through 12 reissuances of the Regulations, during which the relevant sections

of the statute were reenacted in seven Revenue Acts and in the codifications of 1939 and 1954. Under the doctrine of long-continued contemporaneous administrative construction, this language must be deemed to accurately reflect the Congressional intent.

The Tax Court found, on the basis of the uncontradicted testimony of five eminent practicing accountants, that Thor was *required* by generally accepted accounting principles to write down excess inventory to net realizable value, and that the procedures utilized by Thor for identifying and valuing the excess inventory conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business. The Commissioner produced no evidence and gave no reason why Thor's inventory procedures did not clearly reflect its income. Thus, the Tax Court's findings required a holding, based on the language of the Regulations under § 446 and § 471, that Thor's income was clearly reflected by its inventory procedures.

Such a holding would be consonant with an unbroken line of decisions of other courts, particularly the decisions of Courts of Appeals for the Fifth, Sixth and Tenth Circuits, as well as an earlier decision by the Seventh Circuit, which hold that, if a taxpayer's inventory procedures conform to generally accepted accounting principles, they constitute the best accounting practice, and therefore clearly reflect income.

The courts below, in disregard of the Congressional intent and the long-continued administrative interpretation, accord the Commissioner the discretion, *independent of any defined standard,* to determine that a taxpayer's accounting procedures do not clearly reflect income. This discretion is founded principally on the interrelated misconceptions that the prepaid income cases, *Schlude* v. *Commissioner*, 372 U. S. 128 (1963), and *American Automobile Ass'n* v. *United States,* 367 U. S. 687 (1961), give the Commissioner the authority to ignore generally accepted accounting principles even in the inventory area, which

was not involved in those cases; that financial accounting does not adequately measure annual income; and that case law establishes the rule that the Commissioner's determination in inventory accounting matters will not be set aside unless it is "plainly arbitrary". None of these propositions is supported by the authority cited by the Seventh Circuit or the Tax Court.

Independent of the presumptions of the Regulations, Thor's inventory procedures did clearly reflect its income. Based on the decided cases, the requirements of financial accounting, proven by the expert testimony, and the rules of the Securities and Exchange Commission, which are designed to insure the accuracy of published financial statements, Thor's write-down of inventory to net realizable value was required to clearly reflect its income. If, on the contrary, its excess inventory were not written down until it is scrapped, as the Commissioner would require, Thor's income would be overstated in the year the excess should have been written down and understated in the year it was eventually scrapped.

Thus, the scrapping test insisted on by the Commissioner, which the Seventh Circuit held did not constitute an abuse of his discretion, would violate generally accepted accounting principles, and the S. E. C. would treat published financial statements based on it as "misleading or inaccurate". It follows that the scrapping test would not constitute the "best accounting practice" of Thor's trade or business, nor clearly reflect its income, as is explicitly required of inventory procedures by § 471.

According to the lower courts' analysis, even though a taxpayer's inventory procedures conform to generally accepted accounting principles and constitute the best accounting practice, they do not clearly reflect income unless they are explicitly authorized by the specific provisions of the Regulations. This theory is contrary to the decided cases and to the established practice of the Commissioner, who for over 50 years permitted taxpayers to accumulate inventory costs under standard cost systems even though they were not explicitly authorized by the

Regulations. But most importantly, if silence of the Regulations concerning a procedure means that it *does not* clearly reflect income, this would nullify the presumption of § 1.471-2(b) of the Regulations that an inventory procedure which conforms to the "best accounting practice" *does* clearly reflect income.

Even though the Regulations do not explicitly authorize the writedown of excess inventory, the specific provisions providing for the writedown of subnormal goods (§ 1.471-2(c)) and of normal goods to "market value" (§ 1.471-4) do authorize such writedowns—if they are construed to fulfill the intention of § 471 that inventory procedures for tax purposes are to follow the best accounting practice.

Bad Debt Issue

At the end of 1965, after careful review of each of its accounts over $100, Thor's management decided that an addition to its reserve for bad debts of $168,588 was necessary, principally because of the existence of some $184,000 of long-overdue accounts that Thor determined were uncollectible. The Commissioner did not challenge the accuracy of Thor's determinations, but, without explanation, limited Thor's addition to its reserve by a formula which applied a six-year average of Thor's bad debt chargeoffs to the balance of its receivables at the end of 1965.

Section 166(c) of the Code provides that a taxpayer who has elected the reserve method ". . . shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts" (emphasis added). Treasury Regulation § 1.166-4(b)(1) specifies that:

> "What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. . . ."

The six-year historical average emanates from *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F. 2d

977 (6th Cir. 1942), *acq.* 1944 C. B. 3, in which the taxpayer produce no evidence explaining how it computed its bad debt reserve. In its opinion, the Board of Tax Appeals made it clear that it was not adopting a *per se* standard of what was reasonable, because a formula cannot take into account the particular facts or circumstances affecting the collectibility of the taxpayer's accounts at the end of each year.

The *Black Motor* formula should be confined to situations similar to that in the case from which it originated inasmuch as the formula itself can yield arbitrary results because it directly depends on the bad debt *chargeoff policies* of the taxpayer, which need not be related to the taxpayer's actual bad debt experience or prospects. The fact that the formula is based on chargeoffs is contrary to the clear Congressional intent when it amended the companion provision of § 166(a) in the Revenue Act of 1942 to eliminate the requirement that a taxpayer could not deduct a wholly worthless bad debt until it was written off.

Contrary to the decisions of the Courts of Appeals for the First, Sixth and Ninth Circuits, and the Tax Court, which have held that the Commissioner abused his discretion when he failed to take into account the particular facts and circumstances affecting the accounts receivable at year-end as required by the Regulations, the decisions of the courts below go farther than any reported case in conferring upon the Commissioner *carte blanche* authority to impose the *Black Motor* historical chargeoff formula without regard to the taxpayer's current data on the collectibility of its receivables.

The Commisioner's Discretion

The separate inventory and bad debt valuation issues presented by this case have as their common denominator the extent of the Commissioner's "discretion" in administering the Internal Revenue Code. *Cf. Central Illinois Public Service Co.* v. *United States,* 98 S. Ct. 917 (1978).

On one hand, the Commissioner takes the position that a taxpayer cannot write down unsalable inventory to net realizable value prior to the year when it is scrapped because the Treasury Regulations do not expressly authorize such a writedown. At the same time, the Commissioner ignores the Regulations which require him to consider the current collectibility of a taxpayer's accounts receivable in determining whether a taxpayer's addition to its reserve for bad debts is reasonable.

Despite this inconsistency, the courts below upheld the Commissioner on both issues on the ultimate basis that the taxpayer did not show that the Commissioner had abused his discretion. This conclusion was reached notwithstanding the fact that the Commissioner has offered no explanation to Thor or to either court how Thor's inventory or bad debt valuation procedures were inaccurate or distorted its taxable income.

The lower courts have thus accorded the Commissioner an almost absolute discretion to determine whether or not a taxpayer's inventory and bad debt valuation procedures clearly reflect taxable income. This discretion is granted not to defend the revenues against a tax avoidance scheme or to cope with a unique factual situation, but to invalidate customary inventory and bad debt valuation procedures used by an ordinary manufacturer pursuant to generally accepted accounting principles, as required by his independent public accountants and the S. E. C. Such unprecedented discretion is difficult to reconcile with common law and constitutional foundations which require the law to be administered according to established standards rather than by *ad hoc* administrative determinations.

ARGUMENT

I.

SECTIONS 446 AND 471 OF THE CODE, AND THE TREASURY REGULATIONS PROMULGATED THEREUNDER, PERMIT THE TAXPAYER, IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND THE BEST ACCOUNTING PRACTICE, TO WRITE DOWN EXCESS AND UNSALABLE GOODS IN ITS INVENTORY FROM COST TO NET REALIZABLE VALUE WITHOUT HAVING TO SCRAP THEM

The decisions of the courts below on the inventory issue are the first, so far as Thor can ascertain, in which any court has held that the Commissioner has virtually *carte blanche* discretion to set aside inventory valuation procedures used by a taxpayer in calculating his taxable income, even though such procedures, consistent with § 446 of the Code, fully conform to generally accepted accounting principles, and constitute "the best accounting practice" in the taxpayer's trade or business within the meaning of § 471 of the Code. The courts' conclusion is not supported by the language of either Code section, and is contrary to their legislative history, as well as to the language of the Treasury Regulations interpreting them.

In recent years, without any change in the Code or applicable Treasury Regulations, the Commissioner commenced disallowing writedowns of excess and unsalable inventory prior to the year when such inventory is scrapped. This policy adversely affects thousands of manufacturers of most products, as well as wholesalers and retailers of them, who must maintain extensive stocks of replacement parts to serve the needs of their customers. A few examples are manufacturers and dealers of factory, construction and farm machinery; automobiles and other vehicles;

computers and office equipment; household appliances; and television and audio products. Because it is impossible to accurately predict how frequently a particular part is going to wear out, break or malfunction, service parts customarily are produced and stocked in quantities exceeding the number that eventually will be sold. These excess parts are retained in inventory until there is little or no customer demand for them, at which time they are scrapped.

The Commissioner's position—that excess inventory cannot be written down until it is scrapped—leaves the manufacturer with an unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such overvaluation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers. The manufacturer must make this choice even though it has been writing down excess inventory for years according to customary industry practice without any objection from the Commissioner. In fact, at one time Internal Revenue Service auditors would approve such a writedown if the taxpayer could establish its accuracy. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N. Y. U. Institute on Federal Taxation 839, 850 (1965).

The issues in this case run deeper than the specific inventory valuation question here presented, even though that in itself involves significant tax liability to thousands of businesses. A fundamental policy issue is whether tax accounting should follow generally accepted accounting principles where the taxpayer's procedures are required by normal business needs and are not motivated by tax avoidance. This was the original intention of Congress when it enacted the Revenue Act of 1918, clearly reiterated by it when the 1954 Code was adopted. If, except for express statutory exceptions,* tax accounting conformed

* See, *e.g.*, § 174 (research and experimental expenditures); § 169 (amortization of pollution control facilities); § 616 (expenditures for developing natural resources).

to generally accepted accounting principles, taxpayers would obtain the great benefit of predictability. The Commissioner would receive a reciprocal benefit in that independent public accountants would be professionally obligated, in performing their audit functions, to ensure that their clients' accounting methods and procedures consistently satisfied a single standard applicable equally to both financial and tax accounting.*

An even more basic policy matter is whether the Commissioner should have virtually *ad hoc* discretion in administering such sections of the Code as § 446 and § 471. The Commissioner asserts that Thor's writedown of excess inventory does not clearly state its taxable income, but he has offered no explanation to Thor, or to the courts below, how it does not—or why it was necessary, or even reasonable, for tax accounting to depart from generally accepted accounting principles in valuing excess inventory. Although Thor knows of no established standard other than generally accepted accounting principles for determining whether or not inventory procedures clearly reflect income, this objective standard is treated as irrelevant by both lower courts in favor of an unexplained determination by the Commissioner that Thor's procedures did not clearly reflect its income. In a somewhat different context, this Court recently pointed out that the Commissioner does not have "unfettered discretion," but must look to the intent of Congress in administering the Code, *Central Illinois Public Service Co.* v. *United States*, 98 S. Ct. 917 (1978), especially concurring opinion by Brennan, J., *id.* at 923.

* Since the United Kingdom adopted its first income tax shortly after the American Revolution, it has placed primary responsibility upon chartered accountants in seeing to it that their clients correctly report their income for tax purposes. This system is mutually praised as both protecting the revenues and enhancing taxpayer morale in a country which, similar to the United States, imposes an income tax at high rates on a self-assessment basis. It is also noteworthy that, with statutory exceptions, the definition of "chargeable profits" is based on the concepts of financial accounting. See *Odeon Associated Theatres Ltd.* v. *Jones (Inspector of Taxes)*, [1972] 1 All E. R. 681; [1972] 2 W. L. R. 331.

A. Thor's Writedown of Excess Inventory to Net Realizable Value, Which Is Required by Generally Accepted Accounting Principles and Constitutes the Best Accounting Practice in Thor's Trade or Business, Is Presumed by Sections 446 and 471 of the Code, as Interpreted by Treasury Regulations Thereunder, to Clearly Reflect Thor's Taxable Income

Inventory procedures are subject both to the rules of § 446, which govern tax accounting generally, and to the more specific standards of § 471, which regulate the determination of inventories.

Section 446 imposes the requirement that the method of accounting by which the taxpayer keeps his books is to be followed for income tax purposes unless it "does not clearly reflect income". Section 471 applies a dual standard that a taxpayer's inventory must conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income".

The legislative history of these statutory provisions, and of the Treasury Regulations interpreting them, clearly establishes that the two concepts of generally accepted accounting principles and clearly reflecting income are related and not antithetical. Since the Revenue Act of 1918, the Regulations have recognized that conformance to generally accepted accounting principles (prior to the 1954 Code, "approved standard methods of accounting") will "ordinarily" or "as a general rule" be regarded as "clearly reflecting income", and the Committee Reports accompanying the 1954 Code in almost *haec verba* stated that to be the intent of Congress.

The requirements of both sections of the Code were fulfilled when the Tax Court found that generally accepted accounting principles required Thor to write down its excess inventory to net realizable value, and that Thor's procedures for doing so conformed to generally accepted accounting principles and

constituted the best accounting practice in its trade or business (Pet. A-15, A-19–A-20, quoted at pp. 13-14, *supra*). Inasmuch as the Commissioner introduced no evidence whatsoever that Thor's inventory valuation procedures did not clearly reflect its income, the findings of the Tax Court should be dispositive of the inventory issue as a matter of law.

I.

Section 446(a) of the Code states in mandatory language:

> "Taxable income *shall* be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." (Emphasis added.)

Section 446(b) permits the Commissioner to require a different method of accounting only if the taxpayer's method "does not clearly reflect income".* Otherwise the taxpayer's accounting method, including "the accounting treatment of any item" (Treas. Reg. § 1.446-1(a)(1)) such as Thor's writedown procedures for excess inventory, is controlling for tax accounting purposes.

The initial version of Treasury Regulation § 1.446-1(a)(2) under the 1954 Code interpreted the statute as follows:**

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that

* The House and Senate Committee Reports do not contain any substantive explanation of § 446(b). See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A157-58 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 299-300 (1954).

** T. D. 6282 (filed December 24, 1957), 1958-1 C. B. 215, republished without change in T. D. 6500 (filed November 25, 1960), 25 Fed. Reg. 11708 (1960).

> trade or business *will ordinarily be regarded as clearly reflecting income*. . . ." (Emphasis added.)

The final sentence of this excerpt is almost identical to that in the discussion of § 446 in the Reports of the House and the Senate accompanying the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954), both of which state:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income."*

The substance of both the statutory and regulatory provisions originates with the Revenue Act of 1918 and Treasury Regulations 45 interpreting it. Section 212(b) of that Act, 40 Stat. 1057, 1064 (1919), provided:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but . . . if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . ."

Except for minor editorial changes, identical language appeared in all subsequent Revenue Acts and § 41 of the Code of 1939.

* The Congressional Reports are consistent with the ALI Federal Income Tax Statute (February 1954 Draft), which was the origin of the accounting provisions of the 1954 Code. See Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257, 291 n.122 (1954). The ALI's explanation of § X310(a), which became § 446 of the Code, declares at p. 400:

> "This provision sets forth the general approach to tax accounting. It indicates the general dependency of tax accounting on general accounting practice in that the taxpayer's method of accounting for business purposes, subject to certain conditions, is to be his method for determining the time for inclusion and deduction in computing his taxable income."

The substantive concepts of the current Regulation § 1.446-1 (a)(2) under the 1954 Code can be traced to the original Treasury Regulations 45 interpreting the 1918 Act. Article 23 of those Regulations provided: "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."* This language was readopted in all subsequent editions of the Regulations through Regulations 118, § 39.41-2 (1953) under the 1939 Code.

The history of the statute and Regulations is succinctly summarized by Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257, 258 (1954):**

> "Since the advent of the present federal income tax, it has quite apparently been the basic intention that generally accepted accounting principles should govern determinations of taxable income."

The authors observe critically that the intention of Congress was not followed in judicial and administrative interpretations of the Revenue Acts and the 1939 Code, and that these de-

* Article 24 of those initial Regulations contained the language now found in the opening sentences of § 1.446-(1)(a)(2), quoted at p. 28 *supra:*

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, *and the law contemplates* that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose." (Emphasis added.)

Both Articles 23 and 24 appeared in the "preliminary" edition of Regulations 45, published as House Document No. 1826, 65th Cong., 3d Sess. (1919), primarily intended for use by members of the House. This language was republished in each of the four succeeding editions of Regulations 45, including the edition issued January, 1921, by T. D. 3146, known as the "1920 Edition".

** The authority of this article is enhanced by the fact that Messrs. Surrey and Warren were co-reporters of the ALI Federal Income Tax Statute, which was the origin of the accounting provisions of the 1954 Code. See footnote p. 29 *supra.*

partures provided the impetus for the accounting provisions of the 1954 Code.*

Since the adoption of the 1954 Code the courts have followed the renewed Congressional intention at least as to inventory matters. Thus, until the decisions below, Thor can find no case in which the Commissioner has successfully invoked § 446(b) to invalidate a taxpayer's inventory procedure which conformed to generally accepted accounting principles.**

2.

Section 471 of the Code, specifically governing inventory accounting, provides:

> "Whenever . . . the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

This language imposes dual requirements *on both the taxpayer and the Commissioner.* Inventory accounting must: (i) conform

* "This early recognition that it was the purpose of the statute to give effect to basic accounting principles was greatly qualified in important particulars by later judicial and administrative interpretations. [See especially *North Am. Oil Consol.* v. *Burnet*, 286 U. S. 417 (1932).] The development of these interpretations, at variance with commercial accounting principles, is not within the scope of this article. The consequence of the process, however, has been certain serious divergences between rules of tax accounting and generally accepted accounting principles as universally applied in determining net income for commercial management and investment purposes. These divergences were a continuous source of irritating adjustments, which, in the long run, yielded no substantial revenue to the Government because they merely represented shifts of income between years. They provided the background and impetus for the 1954 Code Revision." (Bracketed portion originally in footnote.) 68 Harv. L. Rev. at 258.

** The cases cited by the Tax Court (Pet. A-20–A-21) and by the Seventh Circuit (Pet. A-38, A-40) all involved inventory methods which the courts properly found did *not* conform to generally accepted accounting principles. See discussion at p. 51 *infra.*

as nearly as may be to the best accounting practice in the taxpayer's trade or business, and (ii) clearly reflect the taxpayer's income.

After discussing these two criteria, Treasury Regulation § 1.471-2(b), in effect for the year in question and at the time of trial, stated:

> "It follows, therefore, that *inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.* In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9. *An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.*" (Emphasis added.)*

Just as the Regulations under § 446 state that a method of accounting that conforms to generally accepted accounting principles "ordinarily" will be regarded as clearly reflecting income, the Regulations interpreting § 471 declare that an inventory that qualifies as the best accounting practice can "as a general rule" be regarded as clearly reflecting income.

The origin of § 471 (like § 446) is the Revenue Act of 1918. The language of § 471 repeats almost verbatim § 203 of that

* After trial of this case but before the Tax Court decision, that Regulation was amended by T. D. 7285 (filed September 14, 1973), 1973-2 C. B. 163, to delete the last sentence quoted above. That amendment also deleted the word "substantially" in the penultimate sentence, thus requiring that inventory valuation must be "in accord" with the enumerated specific provisions of the Regulations.

Both courts below, relying on *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939), properly held that the amendment was not applicable to this case (Pet. A-22 and A-39).

Act,* and essentially the same language has been in all intervening Revenue Acts and § 22(c) of the 1939 Code.**

As passed by the House, § 203 did not contain the phrase "as conforming as nearly as may be to the best accounting practice in the trade or business." This language was added by a Senate amendment to the Bill and was adopted in conference without significant discussion. H. R. Rep. No. 1037, 65th Cong., 3d Sess. 45 (1918), 1939-1 C. B. (Part 2) 132. When this same provision was before Congress in the Bill that later became the Revenue Act of 1921, 42 Stat. 227, 231 (1921), there was floor debate in the Senate as to the meaning of the language. Senator Penrose, a member of the Senate Finance Committee and floor leader of the Bill, stated unequivocally that "the law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice."***

* Section 203 of the 1918 Act, 40 Stat. 1057, 1060 (1919) provided:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe *as conforming as nearly as may be to the best accounting practice in the trade or business* and as most clearly reflecting the income." (Emphasis added.)

** Section 471 is a renumbering, without substantive change, of § 22(c) of the 1939 Code. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A164 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 307 (1954).

*** The floor debate included the following colloquy:

> "MR. KING: Mr. President, may I inquire of the committee . . . whether it is the purpose of this amendment to authorize the commissioner to determine the form of inventory which shall be followed by all business houses in the United States that would be subject to these provisions, regardless of the efficiency and honesty of the methods pursued by business houses in carrying their inventories and ascertaining their liabilities, assets, and so forth?
>
> "MR. PENROSE: Mr. President, the provision is existing law, without any alteration, and is now being administered without any great complaint having been called to my attention.

(Footnote continued on next page.)

The origin of the language of § 1.471-2(b) of the Regulations, quoted at pp. 31-32 *supra*, first appeared in Article 1582 of the 1920 Edition of Regulations 45, as amended by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922):*

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income."

This language remained unchanged in substance through all intervening Regulations for 53 years until September, 1973,

(Footnote continued from preceding page.)

Where the books of a concern are accurate and kept in a businesslike way I am informed that they are accepted by the Treasury Department without question.

"* * *

"MR. PENROSE: *The law says that the best accounting practice in the trade or business is to be followed. That is all that is necessary.* There is no trouble about this.

"MR. KING: Let me say to the Senator that there have been some complaints.

"MR. PENROSE: There may be.

"MR. KING: Not many have been brought to my attention, but some, that arbitrary requirements have been made by the department with respect to the form of inventories. Certain businesses have established a method of inventorying their business which have met their requirements, and which are regarded by them and by others as being fair and honest, and a true reflection of the condition of the business; and it has been felt by some that to abandon accepted standards of business, adopted by business men, to conform to the whims and caprices—and I do not use those terms at all offensively—of officials works a very serious hardship.

"MR. PENROSE: Mr. President, if the Senator will pardon the expression, let me take absolute issue with him on that point. *The department does not make any arbitrary rules of accounting. The law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice. They do not put their arbitrary methods in force. . . .*" (Emphasis added.) 61 Cong. Rec. (Part 6) 5809 (1921).

* In A. R. R. 921, I-1 C. B. 126 (1922), Article 1584 as amended by T. D. 3296, was applied to the years 1917 and 1919, thus indicating that the amendment was effective retroactively to the outset of Regulations 45.

after the trial of this case but before the Tax Court's decision, when the very sentence upon which Thor relies was deleted from the Regulation. See fn. at p. 32 *supra*. There was no legislation nor any court decision requiring or even supporting this restrictive amendment to the Regulation.

During the 60 years from the enactment of the 1918 Act until the decisions of the courts below, to Thor's knowledge no court has held that a taxpayer's inventory procedure which constituted the best accounting practice in the taxpayer's trade or business did not clearly reflect the taxpayer's income.*

3.

The history of both § 446 and § 471, and of the Treasury Regulations interpreting them, presents a classic case for applying the doctrine of long-continued contemporaneous administrative construction.

This Court consistently has held that when an agency charged with the administration of a statute has construed that statute contemporaneously with its enactment, and has applied that interpretation uniformly for a substantial period of time, the original interpretation will be followed notwithstanding a subsequent attempt by the administrative agency to change it.

Leading authority is *United States* v. *Leslie Salt Co.*, 350 U. S. 383 (1956). In holding that the Treasury could not reverse its long-standing interpretation that certain types of promissory

* The cases cited by the Tax Court (Pet. A-20–A-21) and by the Seventh Circuit (Pet. A-38, A-40) all involved inventory methods which the courts properly found did not conform to generally accepted accounting principles and did not constitute the best accounting practice. See discussion at p. 51 *infra*.

The cases invalidating the LIFO method, *e.g.*, *Marshall-Wells Co.* v. *United States*, 59 F. 2d 106 (Ct. Cl. 1932); I. T. 1560, II-1 C. B. 29 (1923), are not an exception to the statement in the text because the LIFO method of accounting was not approved as a generally accepted accounting principle until July, 1947, by Accounting Research Bulletin No. 29 of the AICPA Accounting Principles Board.

notes were not "debentures" or "certificates of indebtedness" and therefore were not subject to Federal documentary stamp taxes, this Court stated, *id.* at 396-97:

> "There are persuasive reasons for construing 'debentures' and 'certificates of indebtedness' in accordance with the Treasury's original interpretation of those terms in this statute's altogether comparable predecessors. In *Norwegian Nitrogen Prod. Co.* v. *United States,* 288 U.S. 294, 315, Mr. Justice Cardozo said:
>
> > "'administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. . . . The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new.'
>
> "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand."

See also *Cory Corp.* v. *Sauber,* 363 U. S. 709, 712 (1960) (*per curiam*); *Fribourg Navigation Co.* v. *Commissioner,* 383 U. S. 272, 283 (1966), and *Canada Packers, Ltd.* v. *Atchison, T. & S. F. Ry.,* 385 U. S. 182, 183-84 (1966) (*per curiam*).

The force of the rule is enhanced when Congress has reenacted the statutory section unchanged while the administrative precedent construing it is accumulating. In *Fribourg Navigation Co.* v. *Commissioner, supra,* this Court stated, 383 U. S. at 283:

> "Over the same extended period of years during which the foregoing administrative and judicial precedent was accumulating, Congress repeatedly re-enacted the depreciation provision without significant change. Thus, beyond the generally understood scope of the depreciation provision itself, the Commissioner's prior long-standing and consistent administrative practice must be deemed to have received congressional approval. See, *e.g., Cammarano* v. *United States,* 358 U.S. 498, 510-511; *United States* v. *Leslie Salt Co.,* 350 U.S. 383, 396-97; *Helvering* v. *Winmill,* 305 U.S. 79, 83."

The original administrative construction by the Treasury under both § 446 and § 471 remained unchanged for over a half-century through 12 reissuances and many amendments of the Regulations. During this period the statute was reenacted seven times as Revenue Acts, codified in 1939, and recodified in 1954. This history is strong confirmation that Congress has approved the original interpretation of the Treasury Regulations under both sections that if a taxpayer's accounting method embodies generally accepted accounting principles and constitutes the best accounting practice, it "ordinarily" or "as a general rule" will be regarded as clearly reflecting income.*

Whether these long-continued and parallel interpretations of § 446 and § 471 by the Treasury Regulations are regarded as establishing either a general rule or a rebuttable factual presumption under each section, they clearly reflect the original Congressional intention, unmistakably renewed under the 1954 Code. This being so, these interpretations cannot simply be ignored as both the Commissioner and the lower courts have done in this case.

* * *

The findings of the Tax Court that Thor's procedures for writing down excess inventory both conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business, entitled Thor to the

* That the Treasury understood the Congressional intention this way is confirmed by the initial Regulations it issued under the 1954 Code. Regulation § 1.446-1(a)(2), promulgated by T. D. 6282 (filed December 24, 1957), 1958-1 C. B. 215, which incorporated the very language of the House and Senate Committee Reports, quoted at pp. 28-29 *supra.* Similarly, Regulation § 1.471-4(b), promulgated by T. D. 6336 (filed December 1, 1958), 1958-2 C. B. 176, continued the same language that first had been in Regulations 45, quoted at p. 34, *supra.*

benefit of the presumptions or general rules under both statutory sections. Inasmuch as the Commissioner introduced no evidence which rebutted them or showed that an exception should apply, they established under both sections that Thor's taxable income was clearly reflected. This should have determined the issue.

B. The Courts Have Uniformly Held, Consistent with the Congressional Intention, That a Taxpayer's Income Is Clearly Reflected by Accounting Procedures That Conform to Generally Accepted Accounting Principles and Constitute the Best Accounting Practice

The Courts of Appeals for the Fifth, Sixth and Tenth Circuits, as well as trial courts, have sustained the Congressional intention by uniformly holding that a taxpayer's inventory method clearly reflects income if it conforms to generally accepted accounting principles and constitutes the best accounting practice. In fact, the Seventh Circuit adopted this position in an earlier decision.

In *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N. D. Ohio 1963), in which the Sixth Circuit adopted the District Court's opinion, 351 F. 2d 449 (6th Cir. 1965), a taxpayer was permitted to write down to net realizable value partially completed presses being built to a customer's specifications under a fixed price contract. The District Court stated, 224 F. Supp. at 382:

> "An evaluation of the evidence outlined above leaves no room for doubt that plaintiff's method of valuing its work in process inventory is in harmony with generally accepted accounting principles. . . . These conclusions are compelled by . . . the testimony of the taxpayer's witnesses, all of whom are certified public accountants of wide and extensive experience in auditing accounts of large publicly owned corporations. . . .
>
> "It was established also that an inventory valued in accordance with generally accepted accounting principles may be considered as one that conforms 'as nearly as may be to the best accounting practice in the trade or business.' "

The Commissioner argued that adherence to generally accepted accounting principles did not necessarily lead to the conclusion that the taxpayer's income was clearly reflected, to which the District Court responded, *id.* at 385:

> "I hold that the plaintiff [taxpayer] has shown by the requisite degree of proof that the Commissioner acted arbitrarily in disallowing the write-down of plaintiff's inventory. . . .
>
> "* * *
>
> "I find further that the inventory was used under the best accounting practice in a balance sheet showing the financial position of the taxpayer and under the *general* rule applicable in such cases is considered as clearly reflecting taxpayer's income." (Emphasis added.)

In *Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144 (5th Cir. 1963), *rev'g* 21 T. C. M. (CCH) 295, P-H TC Mem. Dec. 62-336 (1962), the Fifth Circuit held that a taxpayer incurring a loss in manufacturing military trailers under a fixed price contract was entitled to write down its closing inventory to net realizable value. The Court specifically rejected the Commissioner's arguments, *almost identical to the ones made by him in this case,* that no writedown was permitted because all of the specific requirements of the Regulations were not fulfilled; the goods were not damaged or imperfect; the net realizable value was less than replacement cost; and the loss had not been "realized" because the goods had not yet been delivered.

Describing the following as the "heart of the case", the Court stated, 322 F. 2d at 149:

> "The Regulations echo the statutory emphasis on inventory methods 'conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.' 26 U.S.C.A. § 471; Regulation § 1.471-2. Considering the sharply defined rule that

accounting may be different for business-financial purposes and for tax purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories. 'An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.' Regulation § 1.471-2(b)." (Footnote omitted.)

It concluded its opinion, *id.* at 154-55, with the observation that ". . . it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get."

Monfort of Colorado, Inc. v. *United States*, 561 F. 2d 190 (10th Cir. 1977), *aff'g* 406 F. Supp. 701 (D. Colo. 1976), presented the issue whether gains and losses from cattle futures contracts, purchased by the taxpayer to hedge its cattle inventory costs, could properly be used to adjust closing inventory values. The taxpayer's position was that these gains or losses decreased or increased its inventory cost of the cattle. After finding that the taxpayer's inventory method was consistent with generally accepted accounting principles, *id.* at 196, the Tenth Circuit upheld it, stressing that its decision was ". . . in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs. . . ." *Ibid.* The Court also found that because the taxpayer's method was an "acceptable accounting method" it clearly reflected income, *id.* at 198.

An earlier decision of the Seventh Circuit—unmentioned in the opinion below, although it was referred to in Thor's brief—adopted the same view as the other Circuits. *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918, 920-21 (7th Cir. 1971), *aff'g* 70-1 U. S. Tax Cas. 83,406, 25 Am. Fed. Tax R. 2d 70-1232 (S. D. Ill. 1970), involved the issue whether storage costs and state liquor taxes on whiskey being aged could properly be excluded by the taxpayer from the inventory value

of the whiskey. In holding that it was acceptable to do so, a different panel of the Seventh Circuit reasoned:

"Section 471 provides that the accounting method prescribed should conform as nearly as possible to the best accounting practice in the trade or business and more clearly reflect income. Both the taxpayer and the government introduced the opinions of noted experts on the question of the 'best accounting practice' leading the district court to conclude that 'no uniform method of accounting can be prescribed for all taxpayers.' The government argues that this conclusion is erroneous since use of the superlative 'best' in Section 471 allows but one acceptable accounting method. *We do not believe, however, Congress intended the federal judiciary to decide, as a matter of law, accounting disputes* where there is a wide diversity of expert opinion. *Congress has so indicated by using the phrase 'conforming as nearly as may be * * *'* is Section 471. Paragraph 1.471-2(b) [of the Treasury Regulations] . . . lends additional support: '*Inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.*' . . . We agree with taxpayer that no one accounting principle or case supports the government position since there is no one, single definition of costs." (Emphasis added.)*

The *Van Pickerill* decision is particularly significant because the Seventh Circuit approached that case on the premise that if the taxpayer's procedures were the "best accounting practice," that would determine that its income was clearly reflected. The difference between the parties was the Government's contention, rejected by the court, that there was only one "best accounting practice" which the taxpayer had not followed. If, in the instant case, the Seventh Circuit had followed *Van Pickerill*, it would have held that Thor's inventory procedures clearly reflected its income because Thor's expert testimony established (in contrast to *Van Pickerill* where there was conflicting accounting testi-

* This passage was quoted and followed by the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States*, *supra*, 561 F. 2d at 196.

mony), and the Tax Court found, that Thor's inventory procedures constituted the best accounting practice in its trade or business.*

In an early case, *Lucker* v. *United States*, 53 F. 2d 418, 423-24 (Ct. Cl. 1931), the Court of Claims recognized the Congressional intention and permitted the writeoff of worthless phonograph records, stating, *id.* at 424:

> "Taxation is eminently practical, and we think this is particularly true as to inventories which need only conform to the 'best accounting practice in the trade or business and as most clearly reflect the income.' Not only do we think good accounting practice would require the exclusion of the entire stock of worthless records, but also that a closing inventory at December 31, 1920, *which included these records at any value to the plaintiff, would result in income not being clearly reflected.*" (Emphasis added.)

Fides Publishers Ass'n v. *United States*, 263 F. Supp. 924 (N. D. Ind. 1967) is the only reported case involving excess inventory. There the Commissioner conceded that a publisher was entitled under § 471 to write down an excess stock of books to clearly reflect taxable income, but questioned the taxpayer's formula. The District Court, *id.* at 936, permitted the write-down:

> "It *is conceded that the write-off of such unsalable inventory is proper to accurately reflect net income.* It is allowed by Section 471 of the Internal Revenue Code of 1954, and further it is a customary practice for the book publishing industry. . . . The Government's principle [sic] objection, then, is that the method employed to recompute inventory was improper.
>
> "The inventory write-off was accomplished in the following manner: from the actual inventory on hand was deducted that quantity of books which the taxpayer anticipated would be sold over the next two-year period. The

* *Van Pickerill* is similar to the instant case in another respect because the Treasury Regulation § 1.471-3(c) in effect at that time was silent as to whether or not state taxes and storage costs were to be capitalized in the inventory value.

> remaining inventory was written off as obsolete. The Government . . . attacks the use of a two-year sales period for books of a religious nature which, it is claimed, have a longer useful life than ordinary commercial publications. However, the Government *presented no evidence on the issue* and, to the contrary, the taxpayer's qualified accountant testified that a two-year evaluation of future sales was 'fair for the type of titles you have here.' *This argument, then, has no merit, especially in light of the Government's own Treasury Regulation* § 1.471-2 *which provides that inventory rules must 'give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.'* " (Emphasis added.)

As the testimony of the expert accountants established (A103-A104, A129-A130, A155-A156, A174, A190-A192), it is customary for manufacturers of parts to write down excess inventory quantities to their net realizable value.

See also *Lord Motor Car Co.*, 5 B. T. A. 818, 820 (1926), *acq.* VI-2 C. B. 4 (1927), in which a dealer wrote down used cars by 25% of his cost to what he estimated was fair market value at the time of the inventory. The Tax Court held that the taxpayer's inventory valuation was in conformity with the statute and Article 1582 of Regulations 45 and clearly reflected income.

Two themes can be discerned in these cases. Dominant is acceptance of the Congressional intention that tax accounting, particularly in the complex inventory area, should look to the sophisticated standards of generally accepted accounting principles. Supporting this, the courts, echoing the language of the Regulations, repeatedly refer to "trade customs" and "customary accounting practices" in the particular trade or business. From this viewpoint, the courts have easily concluded that inventory procedures that constitute the best accounting practice in the taxpayer's particular trade or business clearly reflect the taxpayer's income.

C. The Decisions Below Permit the Commissioner to Arbitrarily Determine, Contrary to the Standards Imposed by Sections 446 and 471 and by the Treasury Regulations Thereunder, That Thor's Inventory Procedures Did Not Clearly Reflect Its Income

The Seventh Circuit decision nullifies the intention of § 446 and § 471 and the language of the Treasury Regulations by giving the Commissioner discretion, independent of any defined standard, to determine that a taxpayer's accounting procedures do not clearly reflect its income. According to the Court, the general rule of § 446 need not be applied: "If . . . in the *opinion* of the Commissioner, that method [of the taxpayer] does not clearly reflect income, the Commissioner may require that another method be used" (emphasis added) (Pet. A-38).* As to § 471, the Court says ". . . the accounting profession's indorsement of a practice as 'the best accounting practice,' even if accepted by the Commissioner, does not require him to determine that the practice clearly reflects taxable income" (Pet. A-40). Nowhere in its opinion does the Seventh Circuit indicate what standard the Commissioner is to follow in determining (i) that the presumptions of both sections of the statute are not to be followed or (ii) that the taxpayer's income is not clearly reflected. The Court's silence is consistent with that of the Commissioner, who nowhere in the pleadings, evidence or briefs gives any hint how Thor's inventory procedures failed to clearly reflect its income, but simply repeatedly asserts that they did not.

The Seventh Circuit's position is founded on interrelated misconceptions of case law and the purposes of financial accounting:

(i) that *Schlude* v. *Commissioner*, 372 U. S. 128 (1963), and *American Automobile Ass'n* v. *United States*,

*This is in stark contrast to the language of the statute which requires that the taxpayer's method of accounting be followed unless it does not clearly reflect income—not that it can be rejected *if in the Commissioner's opinion* it does not clearly reflect income.

367 U. S. 687 (1961), accord the Commissioner broad authority to ignore generally accepted accounting principles even in inventory accounting (Pet. A-40);

(ii) that tax accounting need not follow generally accepted accounting principles because financial accounting does not adequately measure income by the annual accounting period as tax accounting requires (Pet. A-40); and

(iii) that case law gives the Commissioner discretion, subject only to not being "plainly arbitrary," to determine that a taxpayer's accounting procedures do not clearly reflect its income (Pet. A-40).

The Court reinforces its position that Thor is not entitled to the usual presumptions of § 446 and § 471 that its accounting procedures clearly reflect income by noting "inferences" in the Tax Court's opinion that Thor's 1964 year-end inventory procedures may not have been consistent with those of earlier years (Pet. A-45).

1.

The Seventh Circuit bases its conclusion—that a finding that the taxpayer's inventory procedure constitutes the best accounting practice does not require a holding that it clearly reflects income—mainly upon the prepaid income cases, *American Automobile Ass'n* v. *United States*, 367 U. S. 687 (1961) and *Schlude* v. *Commissioner*, 372 U. S. 128 (1963).*

* It also relies on a 1930 case, *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264 (1930), in which this Court held that inventories valued according to the "base stock method" did not clearly reflect the taxpayer's income. That inventory method, which is designed to reduce fluctuations in income between years, does not conform to generally accepted accounting principles. It was declared to distort income by T. B. R. 65, 1 C. B. 51 (1919); Article 1582 of the 1920 Edition of Regulations 45, as amended by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922), reiterated the prohibition; and it continues to be prohibited by Regulation § 1.471-2(f)(4). There is no comparable prohibition of Thor's inventory procedures in the Regulations.

Both cases involved, under § 41 of the 1939 Code and § 446 of the 1954 Code, the narrow issue of whether prepaid service income was taxable to an accrual basis taxpayer in the year when payments were received, or could be deferred and amortized over the years when the services were to be rendered. In two 5-4 decisions, this Court held that such income was taxable when received, partly because the taxpayers were unable to adequately match expenses with the related income, 367 U. S. at 691-94; 372 U. S. at 135-37, but principally because of a unique legislative history which showed that Congress did not intend generally accepted accounting principles to govern this limited area of tax accounting, 367 U. S. at 694-98; 372 U. S. at 134-35.

The prepaid income cases are distinguishable from the instant case on both of the grounds underlying those decisions. In those cases the taxpayer was unable to accurately match revenues with expense; Thor's writedown to net realizable value does match inventory losses with revenues (whereas the Commissioner's scrapping test would not). See discussion at pp. 55-56 *infra*.

The comparative legislative history could not be more disparate. With extremely limited exceptions, the deferral of prepaid income had never been allowed for income tax purposes until the enactment of § 452 in the 1954 Code. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. 62-63, 301-03 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 48-49, A159–A160 (1954). This was *retroactively* repealed a year later by the Act of June 15, 1955, 69 Stat. 134 (1955). Section 471 in contrast has remained unchanged over 50 years. This section, which was not mentioned in the prepaid income cases, makes tax accounting for inventories expressly dependent on the "best accounting practice". If that explicit statutory requirement is to be followed, tax accounting for inventories must be based on generally accepted accounting principles. After the repeal of § 452, there was no equivalent requirement for prepaid income.

Nothing in the opinion of this Court in either prepaid income case suggests in the slightest that it was adopting a general policy that tax accounting was to be independent of generally accepted accounting principles as its progenitive authority, contrary to the clear Congressional intention embodied in § 41 of the 1939 Code and § 446 of the 1954 Code. To the contrary, some 15 years after those decisions, their result is one of the only two major non-statutory exceptions—if they accurately can be called "non-statutory" in light of the legislative history—to the rule that tax accounting follows generally accepted accounting principles.*

The scope of the prepaid income cases may be discerned from a recent decision of this Court, which looked to "accepted accounting methods" to determine whether the substance of a sale-and-leaseback transaction was consonant with its form for purposes of determining who was entitled to certain deductions under § 163(a), *Frank Lyon Co.* v. *United States,* 46 U. S. L. W. 4313, 4317-18 (1978). This Court relied on financial accounting rules even though it noted that "the characterization of a transaction for financial accounting purposes . . . and for tax purposes . . . need not necessarily be the same." *Id.* at 4317.

The Court of Claims cogently appraised the scope of the prepaid income cases in *Cincinnati, N. O. & T. P. Ry.* v. *United States,* 424 F. 2d 563, 570 (Ct. Cl. 1970) (*per curiam*):

> "While the *American Automobile Ass'n* and *Schlude* decisions held that in the limited context of the accounting for received but unearned income the generally accepted method of accounting for such receipts does not clearly reflect income for tax purposes, those cases do not establish a general rule abrogating the presumption of correctness

* The other exception is reserves for expenses to be incurred in the future, which are generally prohibited by tax accounting rules. See, *e.g.*, *Brown* v. *Helvering,* 291 U. S. 193 (1934). This exception has a legislative history parallel to that for prepaid income. As enacted, the 1954 Code included § 462 permitting taxpayers to deduct certain expense reserves that would be permitted under generally accepted accounting principles. This section was repealed retroactively along with § 452 by the Act of June 15, 1955, 69 Stat. 134 (1955).

afforded by the regulations, Treas. Reg. 111, § 29.41-2, Treas. Reg. 1.446-1(a)(2), to generally accepted accounting methods. *Schlude* and *American Automobile Ass'n* are based on the peculiar statutory history of the treatment by Congress of unearned, received income, and on the finding that for tax purposes the generally accepted methods treated such income in an 'artifical' [sic] manner . . ." (Footnote omitted.)

This reasoning led to the holding that, because an I. C. C. rule requiring railroads to expense rather than capitalize purchases of property costing less than $500 was in accordance with generally accepted accounting principles, its application resulted in the railroad's taxable income being clearly reflected. *Id.* at 570-71.

2.

The Seventh Circuit's belief that financial accounting does not measure income by annual periods contradicts common knowledge and all financial accounting authority.*

The American Institute of Certified Public Accountants' ("AICPA") Accounting Principles Board Statement No. 4, entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," issued October, 1970, declares in Chapter 2:

> "Changes in Financial Position—The Income Statement. The income statement *for a period* . . . presents an indication in conformity with generally accepted accounting

* All excerpts in the text are from opinions of the Accounting Principles Board of the American Institute of Certified Public Accountants. The S. E. C. has announced that these pronouncements of the Board, together with those of its successor, the Financial Accounting Standards Board, constitute "substantial authoritative support" in determining whether financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934 are prepared in accordance with generally accepted accounting principles. S. E. C. Accounting Series Release No. 150 (December 20, 1973), 39 Fed. Reg. 1260 (1974). That same Release states that financial statements not prepared on the basis of such substantial authoritative support will be considered "misleading or inaccurate". See pp. 56-58, *infra.*

> principles of the results of the enterprise's profit-directed activities *during the period*. The information presented in an income statement is *usually considered the most important information provided by financial accounting* because profitability is a paramount concern to those interested in the economic activities of the enterprise." (Emphasis added.)*

Accounting Research Bulletin No. 43 (1961), which the profession regards as the "bible" of what constitutes generally accepted accounting principles (A99–A100), applies those principles to inventory accounting.** Statement 4 of Chapter 4 of ARB 43 specifies:

> ". . . the *major objective* in selecting [an inventory] method should be to choose the one which, under the circum-

* Indeed, if there is a conflict in inventory accounting between accuracy of the income statement, which must show annual income, and accuracy of the balance sheet, the income statement is given preference. This is vividly illustrated in a discussion of the LIFO method of inventory accounting in Chapter 6 of the same Statement of the Accounting Principles Board:

> "172. *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, *the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the balance sheet or other financial statements.* For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices." (Emphasis added.)

** Relevant portions of ARB 43 are in the record as Exhibit 28. The binding effect on the accounting profession of formal opinions issued by the Accounting Principles Board is set out in the introductory material to ARB 43. See also fn. at p. 48 *supra.*

stances, *most clearly reflects periodic income.*" (Emphasis added.)

Contrary to the lower courts' view, this objective is identical to that of tax accounting.

Statement 5 of ARB 43 provides:

> "A departure from the cost basis of pricing the inventory is *required* when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the *current period*. This is generally accomplished by stating such goods at a lower level commonly designated as *market*." (First two emphases added.)

In applying Statement 5, Statement 6 states that "market" value of an inventory item cannot exceed its net realizable value:

> "As used in the phrase *lower of cost or market* the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> > "(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal). . . ."*

The expert witnesses testified that Statements 5 and 6 represent the relevant generally accepted accounting principles governing the valuation of inventory (*e.g.*, A101–A103) and that Thor's procedures conformed to them (see p. 13 *supra*). The Seventh Circuit apparently rejected this accounting authority and expert testimony on the basis of the plainly distinguishable authority of the prepaid income cases and *Lucas* v. *Kansas City Structural Steel Co.*, discussed at pp. 45-48, *supra*.

* This definition was expressly approved for tax accounting purposes in *E. W. Bliss Co.* v. *United States, supra,* 224 F. Supp. 374, 379 (N. D. Ohio 1963), *aff'd on the opinion below,* 351 F. 2d 449 (6th Cir. 1965).

3.

The courts below took the position that, even though Thor's inventory valuation procedures conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business, the Commissioner has discretion to determine that such procedures did not clearly reflect Thor's income, which determination will be upheld unless it is plainly arbitrary (Pet. A-20–A-21, A-40). Not one of the cases relied upon supports this proposition. Two dealt with attempts by taxpayers to defer commission income,* and the others involved inventory procedures plainly inconsistent with generally accepted accounting principles.**

The three recent decisions cited in the preceding footnote are instructive. In each of them, the court found that the taxpayer's accounting procedures *did not conform* to generally accepted accounting principles, and therefore did not clearly reflect income. Because of this threshold finding, the Commissioner was entitled under § 446(b) to require a substitute procedure that did clearly reflect income. It is only this *substitute* procedure that the courts will not set aside unless it is "plainly arbitrary". See *Photo-Sonics, Inc.*, 42 T. C. at 933; *All-Steel Equipment Inc.*, 54 T. C. at 1761, and particularly *Bangor Punta Operations, Inc.* v. *United States,* 466 F. 2d at 935.

* *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *Commissioner* v. *Hansen,* 360 U. S. 446 (1959) (deferral of commission on customer notes discounted by automobile dealers with finance companies).

** *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264, 269 (1930) (improper "base stock" inventory method); *Bangor Punta Operations, Inc.* v. *United States,* 466 F. 2d 930, 934 (7th Cir. 1972); (improper and misapplied "practical capacity method" for allocating manufacturing overhead to inventory); *Photo-Sonics, Inc.*, 42 T. C. 926, 932 (1964), *aff'd,* 357 F. 2d 656 (9th Cir. 1966), *acq.* 1965-2 C. B. 6 (improper "prime cost method" for allocating manufacturing overhead to inventory); *All-Steel Equipment Inc.*, 54 T. C. 1749, 1753 (1970), *aff'd,* 467 F. 2d 1184 (7th Cir. 1972) (same issue as in *Photo-Sonics*).

4.

The Seventh Circuit takes the further position that Thor is not entitled to the presumptions that its income was clearly reflected because of "inferences" in the Tax Court's opinion that ". . . that the excess inventory Thor attempted to write off in 1964 had been accumulated 'over a period of several years' ", which in turn created the "implication" that Thor had not been consistent in its inventory valuation method (Pet. A-45).

This passage is perplexing. Although the Seventh Circuit's opinion acknowledges that the Tax Court did not make findings either on whether Thor had been consistent between 1964 and earlier years, or whether it had changed its method of accounting (Pet. A-41 n. 12, A-45), it does not mention that the Commissioner had the burden of proof on that issue pursuant to the Tax Court's pretrial order.*

The Seventh Circuit's reference to Thor's alleged inconsistency is substantively unsound. The requirement of consistency in tax accounting is directed to protecting the revenues —by prohibiting inconsistency that would result in income escaping tax altogether or in deductions being taken more than once. See generally the Congressional Reports on § 481 of the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A164-165 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 307 (1954); Staff of the Jt. Comm. on Internal Revenue Taxation, 84th Cong., 1st Sess., Summary of the New Provisions of the Internal Revenue Code of 1954 as Agreed to by the Conferees 69 (1955). But in this instance, any inconsistency by Thor *favored* the revenues. If Thor did not sufficiently write down excess inventory prior to 1964, it overstated

* See Thor's pretrial Motion (A14–A18) and the Order of June 14, 1972, granting it (A19). At the commencement of trial, the Tax Court further ruled that:

> ". . . any allegations of the method applied to the inventory as of December 31, 1963 being part of the new matter raised in the Answer, the burden of proof rests on the Respondent [the Commissioner] to come forward with the proof." (A34.)

its taxable income in the earlier years and paid too much tax. Because of this effect, the courts have given taxpayers considerable leeway in choosing the year for judgmental inventory write-downs such as for obsolete inventory. In fact, the usual contention of the Commissioner is that the taxpayer wrote off the inventory too soon. See, *e.g.*, *C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57 (3rd Cir. 1955), *rev'g* 22 T. C. 124 (1954).

The Seventh Circuit's concern with Thor's inferred inconsistency leads to a radical result. A fundamental rule is that if a taxpayer claims too large a deduction or writedown for a particular year, he does not lose the entire deduction or writedown, but is entitled to the portion applicable to that year, and the balance in the year or years in which it properly belongs. The Seventh Circuit uses the consistency issue to deny Thor a writedown *in both 1964 and earlier years*, even though the $927,000 of excess inventory that existed at the end of 1964 must have arisen in one of those years. Instead, because Thor *may have been* "late" in writing down a portion of the excess, the Court would *further delay* the writedown until the inventory eventually is scrapped. This is both illogical and contrary to normal tax practice.

If the law requires the writedown to be made in the year when the inventory becomes excess, the solution is a remand to permit Thor to show when that occurred—a remedy to which Thor is entitled because of the pretrial order of the Tax Court in excluding this very evidence from the initial trial.* However, as will be shown at pp. 70-72 *infra*, the year in which inventory became excess is not relevant, because Thor is entitled according to existing authority to write down the excess inventory for tax purposes in the year when Thor first identifies it as such and writes it down on its books.

* See Thor's pretrial motion (A14–A18) and the Order of June 14, 1972, granting it (A-19).

D. Thor's Writedown of Excess Inventory Clearly Reflected Its Taxable Income

Even if the Seventh Circuit is correct that Thor is not entitled to the presumptions under both § 446 and § 471 that its income was correctly reflected because its inventory writedown procedures conformed to generally accepted accounting principles and constituted the best accounting practice, *and* if the Court is also right that the Commissioner's determination that Thor's procedures did not clearly reflect its income will be upheld unless it was plainly arbitrary, the conclusion is inescapable that Thor's procedures did clearly reflect its taxable income and that therefore the Commissioner's determination to the contrary was plainly arbitrary.

The Seventh Circuit does not question the Tax Court's conclusion that Thor's inventory procedures resulted in its financial income being correctly stated. Although both courts state the proposition, which Thor does not dispute, that taxable income is not *necessarily* the same as financial income, *cf. Frank Lyon Co.* v. *United States*, 46 U. S. L. W. 4313, 4317-18 (1978), Thor's taxable income for 1964 in fact was clearly stated.*

The meaning of the phrase "clearly reflects income" as used in § 446 and § 471 is not self-evident, but must be measured against some standard. Thor is aware of only four possible standards:

(i) the Regulations;

(ii) case law;

* In justifying the Commissioner's determination that Thor's method did not clearly reflect its income, the Court of Appeals states (Pet. A-46) that Thor's accounting experts ". . . did not testify that its 1964 income had been clearly reflected in its tax return . . .". They did not testify concerning "taxable income," because that was the ultimate issue of law before the Court. In fact, trial counsel for the Commissioner objected on that very ground to a question to an expert witness which he believed called for the witness' opinion whether Thor's "taxable income" was clearly reflected (A192–A193).

(iii) generally accepted accounting principles; and

(iv) the rules of the Securities and Exchange Commisison.

Both parties concede that the Regulations do not explicitly provide for the writedown of excess inventory.*

The cases discussed at pp. 38-43 *supra*, establish the rule that the writedown of inventory to net realizable value clearly reflects taxable income. This rule has been applied to work-in-process under fixed price contracts, *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144 (5th Cir. 1963), *rev'g* 21 T. C. M. (CCH) 295, P-H TC Mem. Dec. 62-336 (1962), and *E. W. Bliss Co.* v. *United States*, 351 F. 2d 449 (6th Cir. 1965), *affirming on the opinion below* 224 F. Supp. 374 (N. D. Ohio 1963); obsolete inventory, *Lucker* v. *United States*, 53 F. 2d 418 (Ct. Cl. 1931); and excess inventory, *Fides Publishers Ass'n* v. *United States*, 263 F. Supp. 924 (N. D. Ind. 1967). The rationale of each of those decisions is that the writedown clearly reflected income because it was required by generally accepted accounting principles. The Commissioner has not cited any case to the contrary.

The standards of financial accounting requiring the writedown of excess inventory are clear and undisputed. Each expert testified that unless the excess inventory were written down, Thor's financial income would not have been correctly stated (pp. 12-13 *supra*). Indeed, the expert testimony established that if excess inventory were not written down until it was scrapped, Thor's income would be distorted both in the year when the inventory was determined to be excess and in the years when it eventually was scrapped.**

* Thor contends, pp. 64-70 *infra*, that an interpretation, consistent with the intention of § 471, of the language and purpose of either Regulation § 1.471-4(b) (market value) or § 1.471-2(c) (subnormal goods) permits the writedown of excess inventory.

** This is explained by the testimony of Mr. Frank T. Weston (A192—A193):

"Q. In the event that ending inventory were overstated because of the existence of excess quantities that were not

(Footnote continued on next page.)

That testimony corresponds to common sense. The Commissioner argues that to correctly state income, excess inventory should be carried until it is scrapped at historical cost which is $927,000 more than it is actually worth, and that the taxpayer somehow is distorting income by writing it down to its current net realizable value.

The rules of the Securities and Exchange Commission require the same results as do generally accepted accounting principles. While it is clear that the purposes of the S. E. C. are different from the responsibilities of the Commissioner in administering the income tax law, the issue here is whether Thor's inventory procedures "clearly reflected income". There is no reason why this concept should have a different meaning under § 446 and § 471 of the Code than it does for public financial statements, the accuracy of which is mandated by the Securities Act of 1933 and the Securities and Exchange Act of 1934.*

(Footnote continued from preceding page.)

valued downward to net realizable value, what would the effect of this be on the income for the current year and on the income for future periods?

"* * *

"A. A determination that at December 31 of a given year an inventory contains excess inventory which was, as you stipulate, not reduced to its net realizable value, would result, in fact, in an overstatement of income for that year.

"As to future years, presumably the inventory, if it were sold or scrapped at a price less than its carrying value, that loss would appear in some future period's income statement, and under generally accepted accounting principles, that result would be improper; that is, the charge, the revaluation of the inventory, the write down to net realizable value, should be made in the year during which the nature or [sic] the excess was determined or existed."

* In determining whether or not a taxpayer's accounting procedures clearly reflect its income, this Court has given weight to the accounting concepts of other agencies. See *Commissioner* v. *Idaho Power Co.*, 418 U. S. 1, 14-15 (1974), citing *Cincinnati, N. O. & T. P. Ry.* v. *United States*, 424 F. 2d 563 (Ct. Cl. 1970), which is discussed at pp. 47-48 *supra*. In the *Cincinnati* case the Court of Claims stated, *id.* at 570-71:

(Footnote continued on next page.)

In fulfilling the basic purpose of these Acts to protect investors by requiring the publication of accurate financial data, the S. E. C. long ago adopted the rule that financial statements prepared in accordance with accounting principles for which there is no "substantial authoritative support" are presumed to be "misleading or inaccurate". S. E. C. Accounting Series Release No. 4 (April 25, 1938), 11 Fed. Reg. 10913 (1938). This was reemphasized more recently by the S. E. C. in its Accounting Series Release No. 150 (December 20, 1973), 39 Fed. Reg. 1260 (1974):

> "In the exercise of its statutory authority with respect to the form and content of filings under the Acts, the Commission has the responsibility to assure that investors are provided with adequate information. A significant portion of the necessary information is provided by a set of basic financial statements (including the notes thereto) *which conform to generally accepted accounting principles.*" (Emphasis added.)*

(Footnote continued from preceding page.)

"Another fact which is entitled to appropriate probative value, but which is not conclusive, is the establishment by the ICC of the $500 minimum rule after careful consideration of the railroads' economic position. The testimony reveals that one of the prime considerations of the ICC in establishing the minimum rule was its effect on the ability of the railroads' financial statements to clearly reflect income. The ICC concluded that the imposition of the $500 minimum rule would not distort income. Although the accounting procedures required by the ICC are not binding upon the Commissioner of Internal Revenue. Old Colony R. R. v. Commissioner of Internal Revenue, 284 U. S. 552, 562, 52 S. Ct. 211, 76 L. Ed. 484 (1932), they are entitled to probative weight in the appropriate case. Northern Natural Gas Co. v. O'Malley, 277 F. 2d 128, 137-138 (8th Cir. 1960); Portland General Electric Co. v. United States, 189 F. Supp. 290, 298 (D. Ore. 1960), *aff'd.* 310 F. 2d 877 (9th Cir. 1962)."

* Release No. 150 defined as authoritative the "principles, standards and practices" promulgated by the Financial Accounting Standards Board (the FASB), the Accounting Research Bulletins of the AICPA Committee on Accounting Procedure and the Opinions of the AICPA Accounting Principles Board. See fn. at p. 48 *supra*.

If Thor had failed or refused to write down its excess inventory in preparing its income statements and balance sheets for 1964 and later years, the S. E. C. would have regarded them as inaccurate and misleading because they would have been based on an accounting practice for which there is no authoritative support.* Thor's problems with the S. E. C. would have been compounded because, as the experts testified (A114, A133, A158, A176 and A195), such financial statements would not have been certified (given an unqualified opinion) by Thor's independent public accountants as required by law.**

The overvaluation of inventory has been the subject of S. E. C. scrutiny. A recent example closely in point is *In the Matter of Eugene Testa and W. A. Stebbins*, A. S. R. No. 212, CCH Fed. Sec. L. Rep. ¶ 72,234 (1977), involving disciplinary action by the S. E. C. against the independent accountants for Photon, Inc., for failure to insist on an adequate, timely write-down of "slow moving and other obsolete inventory", which the S. E. C. characterized as evidencing "a marked disregard for generally accepted accounting principles and auditing standards as well as the Commission's Rules and Regulations" in violation of the antifraud and reporting requirements of the 1934 Act.

* The alleged overvaluation of Thor's assets, including inventory, in 1963 and earlier years led to an investigation by the S. E. C. in early 1965, which resulted in Thor amending its S. E. C. Form 10-K for 1964 to provide additional data (see Ex. S amending Ex. R).

** See § 13(a)(2), 15 U. S. C. § 78m(a)(2) (1976), and § 14(a), 15 U. S. C. § 78n(a) (1976), of the Securities Exchange Act of 1934; Rules 13a-1, 17 C. F. R. 240.13a-1 (1977), and 14a-3(b)(3), 17 C. F. R. 240.14a-3(b)(3) (1977), and Form 10-K thereunder; and Rule 2-02 of Regulation S-X (the S. E. C. regulation governing the form and content of financial statements filed under the Federal securities laws). The remedies available to the S. E. C. would include suspension of trading of Thor's securities, § 12(k) of the 1934 Act, 15 U. S. C. §78*l*(h) (1976), or injunctive proceedings, § 21(d), 15 U. S. C. § 78u(d) (1976). Thor would also be subject to express civil liabilities under § 18(a), 15 U. S. C. § 78r(a) (1976), and implied civil liabilities under Rule 10b-5, 17 C. F. R. 240.10b-5 (1977), and § 14(a), 15 U. S. C. § 78n(a) (1976). To the extent Thor's actions were deemed willful, it would be subject to criminal sanctions under § 32, 15 U. S. C. § 78ff (1976).

The S. E. C. specifically referred to a failure to write off inventory indicated as slow moving by a "usage test" performed by the accountants.*

* * *

Thus, the case law, generally accepted accounting principles as expounded by the uncontradicted testimony of the expert witnesses and by authoritative accounting publications, and the rules and practice of the S. E. C., uniformly point to the unequivocal conclusion that excess inventory must be written down to net realizable value in order to clearly reflect income. Against this array of authority, the courts below upheld the Commissioner's unexplained determination that Thor's inventory procedures somehow did not clearly reflect its taxable income.

E. The Requirement That Excess Inventory Be Valued at Cost Until It Is Scrapped Does Not Constitute the Best Accounting Practice or Clearly Reflect Income and Thus Is Contrary to the Requirements of Sections 446 and 471 of the Code

The Court of Appeals concluded that the Commissioner was entitled, "in exercising his broad discretion under § 471", to require excess inventory to be scrapped as a prerequisite to its writedown to net realizable value on the theory that, in contrast to financial accounting, tax accounting requires "realization" by closed transactions or identifiable events (Pet. A-46–A-47). None of the cases cited by the Seventh Circuit supports its thesis that inventory cannot be written down without

* For other recent S. E. C. proceedings based on overvaluation of inventory or other assets or contrary to generally accepted principles, see *In the Matter of Peat, Marwick, Mitchell & Co.*, A. S. R. No. 173, CCH Fed. Sec. L. Rep. ¶ 72,195 (1975) (improper failure to write off estimated production costs included in inventory under program cost method); *In the Matter of Seidman & Seidman*, A. S. R. No. 196, CCH Fed. Sec. L. Rep. ¶ 72,218 (1976) (inadequate reserves for losses on receivables); *In the Matter of Hertz, Herson & Co.*, A. S. R. No. 176, CCH Fed. Sec. L. Rep. ¶ 72,198 (1975) (inadequate bad debt reserve).

realization.* On the contrary, realization has never been applied to the writedown of inventory to the lower-of-cost-or-market. See discussion in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F. 2d 144, 147-48 (5th Cir. 1963), citing *Sharp* v. *Commissioner,* 224 F. 2d 920, 924 (6th Cir. 1954) rejecting the Commissioner's contention that work-in-process cannot be written down because there was no realization of the loss by sale or scrapping. Similarly, since Article 1582 was added to Regulations 45 in 1922 by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922), the Regulations have permitted the writedown of subnormal goods without scrapping. This was recognized in A. R. R. 921, I-1 C. B. 126, 130-31 (1922), declared obsolete by Rev. Ruling 68-674, 1968-2 C. B. 609.

The issue is settled, however, by the express language of § 471, which requires that inventories must constitute a best accounting practice and must clearly reflect income. The scrapping test cannot be a best accounting practice because it violates generally accepted accounting principles, as the testimony of the expert accountants established. See discussion at pp. 55-56, *supra.* Based on the authority of the existing case law, generally accepted accounting principles, and the S. E. C. rules, the scrapping test also violates the other requirement of § 471 that the inventory practice clearly reflect income.

Implicit in the Seventh Circuit's opinion (Pet. A-46) and explicit in the Tax Court's,** is the belief that requiring excess

* *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *United States* v. *American Can Co.,* 280 U. S. 412 (1930) (*write-up* of inventory from cost to a higher market value by the taxpayer); *American Can Co.* v. *Bowers,* 35 F. 2d 832 (2d Cir. 1929), *cert. denied,* 281 U. S. 736 (1930) (*write-up* of inventory from cost to a higher market value); *Lucas* v. *American Code Co.,* 280 U. S. 445 (1930) (reserve for contingent commission liability that was the subject of litigation).

** The Tax Court directly expressed its rationale by observing that the writedown of excess inventory ". . . based upon an otherwise unsupported opinion of the taxpayer as to its ultimate

(Footnote continued on next page.)

goods to be physically scrapped before they can be written off for tax purposes protects the revenues against taxpayer abuse by providing a more concrete standard than writeoff procedures. Thor submits that this concern is misplaced. Generally accepted accounting principles require that unsalable excess inventory be written down when it is identified as such. Thor's writedowns were directly based on the actual sales (or usage in production) of each item each year. This system automatically inhibits taxpayer manipulation, because it would be senseless for Thor to reduce sales (or production) in order to obtain larger writeoffs for excess inventory.

In contrast, under the scrapping standard, the taxpayer will have possession of excess quantities of goods which have already been written down for financial accounting purposes, as his independent accountants and the S. E. C. require, so he will have greater freedom to arbitrarily choose the year in which to scrap such goods to maximize tax benefits. Thus, the theory that the revenues will be protected by requiring scrapping is dubious at best.

F. Thor's Inventory Valuation Procedures Do Not Need to Be Explicitly Authorized by the Treasury Regulations in Order to Clearly Reflect Income

In deciding that Thor's procedures did not clearly reflect its taxable income, the Seventh Circuit analyzed the specific provisions of the Regulations necessarily on the tacit premise that unless the Regulations explicitly authorize a particular inventory procedure, it does not clearly reflect income (Pet. A-41).* That premise, unsupported by authority or reason, determines the

(Footnote continued from preceding page.)

salability . . . would, within some u known limits, permit the taxpayer to determine how much tax it wanted to pay for a given year" (Pet. A-26).

* The Tax Court was explicit in holding that in order to clearly reflect income, Thor's inventory procedures had to be authorized by the specific sections of the Regulations (Pet. A-23).

outcome, because the Commissioner, Thor and both lower courts agree that the Regulations do not explicitly provide for the writedown of excess inventory.

Neither of the lower courts cites any cases for the proposition that silence or ambiguity of the Regulations constitutes a prohibition, nor has Thor been able to find any. Rather, the cases establish the rule that an inventory procedure is permissible so long as it is neither *prohibited by* nor *inconsistent with* the Regulations. In *Monfort of Colorado, Inc.* v. *United States,* 561 F. 2d 190, 196 (10th Cir. 1977), discussed at p. 40 *supra,* the Tenth Circuit upheld the taxpayer's inventory method because, *inter alia,* it was not prohibited by the Regulations, stating:

> "We deem it significant to note that the IRS expert acknowledged that there was nothing in the regulations, to the best of his knowledge, which prohibited Monfort's tax treatment of hedging gains/losses. Under the circumstances, we will not hold that there is but one way and one way only for Monfort to value its ending inventories."

The Court stressed that its decision was ". . . in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs. . ." *ibid.*

The Tax Court has regularly applied the same rule. See *Fort Howard Paper Co.,* 49 T. C. 275, 285-86 (1967), distinguishing *Photo-Sonics, Inc.,* 42 T. C. 926 (1964), *aff'd,* 357 F. 2d 656 (9th Cir. 1966), *acq.* 1965-2 C. B. 6. In *Hutzler Brothers Co.,* 8 T. C. 14, 27-28 (1947), the Commissioner's contention that the LIFO inventory method could not be combined with the retail sales method in the absence of authorization by the Regulations was rejected by the Court:

> "All of the regulations are as consistent with petitioner's position as they are with that of respondent. . . . It is simpler and more rewarding to seek the meaning of the statute itself than of ambiguous and largely irrelevant administrative interpretations." (Footnote omitted.)

Quite apart from this authority, the failure of the Regulations to explicitly authorize a particular inventory procedure cannot mean that that procedure *does not* clearly reflect income, for this would nullify the presumption of § 1.471-2(b) of the Regulations, in the Regulations since 1920, that an inventory procedure which conforms to the "best accounting practice" ordinarily *does* clearly reflect income. As has been shown, that long-continued administrative interpretation in the Regulations has Congressional approval. See discussion at pp. 35-38 *supra.*

It is also clear that until the amendments of 1973, the Regulations never purported to require that an accounting procedure had to be "in accord" with the specific provisions of the Regulations. See footnote at p. 32 *supra.*

The Commissioner's actual practice since 1918 contradicts the assertion that inventory procedures must be explicitly authorized by the Regulations to clearly reflect income. Until § 1.471-11 was added in 1973, the Regulations contained only primitive guidance to manufacturers for determining cost—notwithstanding that cost is the starting point of inventory valuation, conceptually its most important element. Prior to that year, the Regulations did not specify how indirect manufacturing overhead was to be allocated to inventory (now in § 1.471-11(c)(2)), and did not authorize the use of either a standard cost method or a manufacturing burden rate system (now in § 1.471-11(d)). Yet Thor has found no case in which the Commissioner took the position that a manufacturer was not entitled to allocate manufacturing overhead to inventory by any of these cost accounting methods because they were not explicitly authorized by the Regulations.

To treat the silence of the Regulations as prohibitory in the instant case would be patently unfair because the Treasury has been aware, at least since the early 1960's, that the Regulations do not contain any explicit guidance for valuing excess inventory. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude,* 23 N. Y. U. Institute

on Federal Taxation 839, 850 (1965). The Regulations have yet to be amended to cure this defect, notwithstanding repeated criticism for the omission. See *e.g.* the Statement by the AICPA Division of Federal Taxation, submitted in 1972 at the request of the Internal Revenue Service on the then pending amendments to the inventory Regulations under § 471 (Ex. 29, A151, A223).

G. Thor's Inventory Valuation Procedures Are Authorized by a Construction of the Treasury Regulations That Conforms to the Intention of Section 471 of the Code

Even though Thor is entitled, for the reasons already given, to write down its excess inventory to net realizable value regardless whether detailed provisions of the Regulations expressly authorize it, in fact two provisions of the Regulations, construed to effect the basic intention of § 471, do authorize such a writedown.

These are the Regulations governing the writedown of normal goods from cost to market (§ 1.471-4(b)) and permitting the writedown of subnormal goods (§ 1.471-2(c)). Neither explicitly covers excess inventory, but both embody, albeit imperfectly, the generally accepted accounting principle that goods in inventory should not be valued at more than net realizable value. See Statement 6, Chapter 4, of AICPA Accounting Research Bulletin No. 43, quoted at p. 50, *supra*.

1.

Treasury Regulation § 1.471-4(b) provides for a writedown of normal goods to net realizable value when *market conditions are not normal:*

> "*Where no open market exists* or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory *as may be available*. . . . Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined [in § 1.471.4(a)], the inventory may be valued at such prices less direct cost of disposition. . . ." (Emphasis added.)

Although this does not refer to the valuation of excess inventory, it does evince an intention to permit the writedown of normal goods in an inventory to their net realizable value when market supply and demand conditions make impractical the usual rules for determining "fair market price". The testimony of Thor's president (Pet. A-14, A61–A62) and of the expert witnesses (*e.g.*, A129–A130) establishes that normal market conditions do not exist for parts and accessories which are purchased only by a limited number of owners of a particular tool who need to replace a broken or worn part.

The Court of Appeals, citing inapposite cases,* held that this Regulation was not applicable because Thor intentionally and regularly produced excess quantities of parts, so the existence of the excess was not an "exceptional circumstance permitting their market valuation to be set at other than their replacement cost" (Pet. A-43). Nothing in the Regulation refers even inferentially to "exceptional circumstances" or to why goods are produced. All manufactured products are intentionally produced. Even though parts are deliberately manufactured in liberal quantities to forestall uneconomical production reruns, the manufacturer does not intend them to become excess any more than a retailer intends merchandise he purchases to become obsolete, even though he knows that a portion eventually will.

This Regulation exclusively and realistically focuses on the *market conditions* affecting the salability of inventory, and in

* *Knapp King-Size Corp.* v. *United States*, 527 F. 2d 1392, 1399-1400 (Ct. Cl. 1975) ("fair market value" is based upon reproduction cost, not upon *higher* resale value); *D. Loveman & Son Export Corp.*, 34 T. C. 776 (1960), *aff'd on opinion below*, 296 F. 2d 732 (6th Cir. 1961), *cert. denied*, 369 U. S. 860 (1962) (when net realizable value is in *excess* of cost, "market" is actual replacement cost and not lower "published prices" unavailable to the taxpayer).

doing so requires that "... the taxpayer must use such evidence of fair market price at the date or dates nearest the inventory *as may be available* . . ." (Emphasis added). In construing similar language under a predecessor to this Regulation,* the District Court in *E. W. Bliss Co.* v. *United States, supra,* 224 F. Supp. 374 (N. D. Ohio 1963), *aff'd on opinion below,* 351 F. 2d 449 (6th Cir. 1965), allowed the taxpayer to write down work-in-process without offering the product for sale, observing that ". . . there can be no open market for a partially finished press built to specifications of a particular purchaser. . . ." 224 F. Supp. at 379. From this, it concluded that in valuing the presses the taxpayer could "use such evidence of fair market price at the date or dates nearest the inventory as may be available." *Ibid.* There similarly is no open market in the usual sense for Thor's replacement parts, each of which is built to the specifications for a particular tool and is useful only to replace a part of such tool.

What Thor did fits both the intention and language of the Regulation. By reasonable procedures, it estimated what quantity of each inventory item was not salable. It then valued that unsalable quantity at net realizable (scrap) value which was its "fair market price" within the meaning of the Regulation.

2.

Section 1.471-2(c), consistent with generally accepted accounting principles, authorizes the writedown of *subnormal* goods in inventory to net realizable value without requiring them to be scrapped:

> "Any goods in an inventory *which are unsalable at normal prices* or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, *or other similar causes* . . . should be valued at bona fide selling prices less direct cost of disposition . . . or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a

* Treas. Reg. 111, § 29.22(c)-4.

> reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date." (Emphasis added.)*

Both lower court opinions ignore the broad intention expressed in the opening language, which specifies "*any* goods in an inventory which are unsalable at normal prices" (emphasis added). This language is followed by a list of examples that does not connote any restrictiveness. Read together the opening language and the examples are directed towards dislocations or insufficiency of market demand, which, as the testimony of Thor's president and the expert witnesses demonstrates (see p. 65, *supra*), surely appertains to parts that are useful only to an owner of a tool who needs a particular replacement part.

Instead of addressing the broad purpose of the Regulation, the Seventh Circuit restrictively concluded that the term "other similar causes" in the Regulation does not apply to excess goods because they are "not distinguishable from other units of inventory" (Pet. A-42). The opinion does not explain the relevance of such a requirement, nor do the cases cited support its conclusion.** This theory seems to have originated with the Tax Court's position that subnormal grounds must have a distinguishing physical defect (Pet. A-27), but that concept is not consistent with the examples listed. Although the Regulation lists types of subnormal goods possessing physical defects, it also includes "odd or broken lots" which do not have any special physical characteristics distinguishing them from non-defective goods in normal lots, but which must be sold at lower prices because the

* This language first appeared in Regulations 45, Art. 1582, added by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922).

** *Lucas* v. *Kansas City Structural Steel Co., supra,* 281 U. S. 264, 270-71 (1930) (involving the improper "base stock method" of valuing inventory); and *Cleveland Automobile Co.* v. *United States,* 70 F. 2d 365, 368-69 (6th Cir.), *cert. denied,* 293 U. S. 563 (1934) (involving an arbitrary writedown by a manufacturer of new automobiles many of which were later sold at full list price).

quantity offered or the mix of goods is not customary in the marketplace. Excess quantities of spare parts are analogous to odd or broken lots, because they represent a quantity unsuitable for actual market conditions, and therefore have lost a portion of their market value. In short, the phrase "other similar causes" manifests, under the doctrine of *ejusdem generis,* an intention of the Treasury that situations similar to (though not exactly the same as) the examples given are to be similarly treated.

The Seventh Circuit further narrowly construed the Regulation by literally reading the last sentence of it to require Thor to offer excess finished tools, parts and accessories at scrap value prices within 30 days of the year-end valuation date as a prerequisite to writing them down.* This literal application of § 1.471-2(c) to worthless goods has not been required by any court to which the issue has been presented. In *Queen City Woodworks & Lumber Co.* v. *Crooks,* 7 F. Supp. 684, 685 (S. D. Mo. 1934), the Court held that it was unrealistic for the Commissioner to require worthless obsolete goods to be offered for sale, perhaps tacitly according to the ancient maxim that the law does not require a useless act. In ***Fides Publishers Ass'n*** v. *United States,* 263 F. Supp. 924, 936 (N. D. Ind. 1967), discussed at pp. 42-43 *supra,* neither the Commissioner nor the Court invoked the 30-day rule incident to permitting current titles held by a publisher in excess of two years supply to be written off. See also ***E. W. Bliss Co.,*** discussed p. 66, ***supra.***

The very nature of excess stock precludes literal application of the 30-day rule. Excess stock by definition exists where a portion of an item in inventory is salable at normal prices, while remaining quantities of that item cannot be sold at any price except as scrap. To meet the 30-day rule, the taxpayer would have to offer to sell the excess quantities at scrap value, while simultaneously attempting to merchandise the salable quantities at normal prices.

* The 30-day rule does not apply to raw materials and work-in-process.

3.

Notwithstanding that in this case the Commissioner seeks a narrow construction of both the market value (§ 1.471-4) and the subnormal goods (§ 1.471-2(c)) Regulations, he recently acknowledged that writedowns for excess stock ***are authorized*** by both of those Regulations. Revenue Procedure 76-28, 1976-2 C. B. 645, 646, governing the changeover by taxpayers to the LIFO method from other inventory methods, provides in § 4.02:

> "Solely for purposes of this Revenue Procedure, so-called 'excess stock' write-downs and percentage write-downs applied to a class or type of goods will be considered as coming within the write-down restoration rules contained herein pertaining to section 1.471-2 of the regulations."

This final version of the Revenue Procedure refers to the subnormal goods provisions (§ 1.471-2(c)); an earlier version referred instead to the market value Regulations (§ 1.471-4).*

* * *

Both lower courts construed the market value and the subnormal goods Regulations narrowly. In doing so, they not only did violence to their plain language, but ignored the purposes of the Regulations, and accordingly departed from the intention

* The earlier version stated, I. R. B. 1976-30, p. 19:

> "For purposes of this Revenue Procedure so-called 'excess stock' write-downs and percentage write-downs applied to a class or type of goods, to the extent they are not otherwise a write-down pursuant to section 1.471-4 of the regulations, will be considered as coming within the write-down restoration rules contained herein."

This change came from Announcement 76-115, I. R. B. 1976-36, p. 16, in which the Commissioner stated:

> "Although there may be situations where excess stock and percentage write-downs should be treated as market write-downs for purposes of section 1.471-4, the Service does not intend this treatment for purposes of Rev. Proc. 76-28. *For purposes other than Rev. Proc. 76-28, the Service will not be precluded from treating excess stock* and percentage *write-downs as market adjustments under section 1.471-4.*" (Emphasis added.)

of § 471 that inventories shall conform to the best accounting practice. This construction, indifferent to the realities of the marketplace, is puzzling in light of the fact that it is the Treasury which failed to amend the Regulations to provide rules for the valuation of excess inventory even though it has been aware of the problem since at least the early 1960's. See pp. 63-64, *supra*.

H. The Writedown of Excess Inventory Is Properly Chargeable Against Taxable Income in the Year When the Excess Is First Identified

Throughout this case, the Commissioner has argued that Thor is not entitled to a writedown for some $927,000 of inventory identified as excess and written down on Thor's books in 1964, but must wait to a later year when that excess is actually scrapped; the Commissioner alternatively has contended that, if inventory is to be written down before it is scrapped, any portion of the excess that developed prior to 1964 should have been written down in such earlier year or years. Because of the Tax Court's pretrial order precluding evidence of when the excess arose (A19), there is nothing in the record as to whether all the $927,000 of excess inventory written down in 1964 actually became excess in that year or whether a portion arose in earlier years.

The Commissioner's alternative position is entirely theoretical. A remand to the Tax Court to determine whether some inventory became excess in an earlier year will have *no* effect on Thor's total income tax liability.* If some of the excess is found to have arisen prior to 1964, Thor will be entitled to the benefit of additional interest on the tax it will have overpaid in the earlier years by failing to take the writedown.

* In the event of a remand, § 6214(b) authorizes the Tax Court to examine the facts relating to 1961 through 1963 to determine which items became excess in each of the years 1961-1963 and adjust Thor's tax liability accordingly. If, as is unlikely, any inventory became excess in 1960 or prior years, the mitigation provision of

(Footnote continued on next page.)

Analogous authority suggests that the proper year for writing down excess inventory is the year in which it is identified as such. This is consistent with the language of the market value Regulation, § 1.471-4(b), quoted at pp. 64-65 *supra*, which is not couched in mandatory language. *Cf. C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57, 59 (3rd Cir. 1955), *rev'g* 22 T. C. 124 (1954) (obsolete goods).

Because identification of items as excess depends upon the interaction between supply and demand and on collateral factors such as technological innovations, changes in marketing strategies, and the like, such identification as excess necessarily involves considerable subjective judgment of management. It would be highly impractical to require taxpayers to amend earlier years' tax returns because excess inventory identified in a later year actually may have developed in the earlier year.

This approach is fair to the revenues because any delay by the taxpayer in recognizing the existence of excess inventory postpones the tax reduction caused by such writedown.

If, contrary to the foregoing, this Court holds that Thor is entitled to write down excess inventory only in the year when the items became excess, this case should be remanded to the Tax Court for the introduction of appropriate evidence. Such a remand is required to preserve Thor's right to introduce such evidence established by the Tax Court's pretrial order of June 14, 1972 (A19), and reiterated by the Court at the end of trial (A207–A208).

(Footnote continued from preceding page.)

§§ 1311 *et seq.* would entitle Thor to a refund for any overpayment of taxes in those years resulting from Thor's failure to write down excess inventory at that time. (It should be noted that although the Tax Court has jurisdiction under § 6214(b), jurisdiction under §§ 1311 *et seq.* is limited to the Federal District Courts and the Court of Claims.)

Thus, between § 6214(b) and §§ 1311 *et seq.*, Thor is entitled to a tax reduction for $927,000 of excess inventory writedowns on December 31, 1964, regardless when (prior to that date) the inventory actually became excess.

II.

THE COURT OF APPEALS ERRED IN HOLDING THAT THE COMMISSIONER HAS DISCRETION TO IGNORE CURRENT FACTS CONCERNING THE COLLECTIBILITY OF A TAXPAYER'S ACCOUNTS BY MECHANICALLY LIMITING THE TAXPAYER'S RESERVE FOR BAD DEBTS TO A SIX-YEAR AVERAGE OF ITS BAD DEBT CHARGEOFFS

The Tax Court found as a fact (Pet. A-16) and the Court of Appeals reiterated (Pet. A-47) that at the close of 1965 the collectibility of each of Thor's accounts receivable over $100 was evaluated by Thor personnel most familiar with the particular account, and that these evaluations were reviewed sequentially by three levels of management. See pp. 15-16 *supra.* These careful and detailed estimates showed that a total reserve of $228,948 was necessary at the end of 1965, requiring an addition of $135,150 to the then existing balance of Thor's bad debt reserve. Of the total reserve required, some $184,000 was attributable to several long-overdue accounts that Thor judged to be wholly uncollectible. There is no suggestion in either opinion below that Thor's evaluation of these accounts was inaccurate in any way. The Commissioner does not contend that it was.

Notwithstanding Thor's exacting procedures, the Commissioner determined that a "reasonable" addition to the reserve was limited by a mechanical formula, first used in *Black Motor Co.,* 41 B. T. A. 300 (1940), *aff'd on other issues,* 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3. The Commissioner divided Thor's total writeoff of receivables during 1965 and the five preceding years by the total of its year-end receivables for those six years. The resulting percentage of 3.128% was applied to Thor's 1965 year-end balance of receivables from customers to calculate a maximum allowable reserve of $154,157. This formula permitted Thor to increase its existing reserve by only $61,359.

The Commissioner's insistence upon application of the *Black Motor* formula in this case is inconsistent both with § 166(c) of the Code, which entitles the taxpayer to a "reasonable" addition to its reserve, and with the express language of Treasury Regulation § 1.166-4(b)(1), which requires that a bad debt reserve ". . . shall be determined in the light of the facts existing at the close of the taxable year. . . ."

Indeed, the decisions below go further than any other reported case in conferring upon the Commissioner *carte blanche* authority to impose the *Black Motor* chargeoff formula without regard to the taxpayer's current data on the collectibility of its receivables. The *Black Motor* formula was never intended to have such sweeping use.

A. Section 166(c) of the Code Authorizes a Deduction for a "Reasonable" Addition to a Reserve for Bad Debts, Which the Treasury Regulation Requires To Be Based on Current Facts

Section 166(c) of the Code provides that a taxpayer, like Thor, who has properly elected the reserve method:

> ". . . shall be allowed (in the *discretion* of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts." (Emphasis added.)

The statute sets forth two distinct requirements: (i) the Commissioner must exercise discretion and (ii) the addition to the reserve must be reasonable.

Treasury Regulation § 1.166-4(b)(1) emphasizes the primacy of current facts in the determination of what constitutes a reasonable addition to a reserve:

> "What constitutes a reasonable addition to a reserve for bad debts *shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition.* The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity." (Emphasis added.)

The Regulation does not mention bad debt chargeoffs of the taxpayer as a factor to be considered.

B. The Black Motor Formula Was Not Intended To Be a Per Se Limitation on a Taxpayer's Bad Debt Reserve, and Should Not Be Used as Such Because It Is Inherently Arbitrary

In the *Black Motor* case, the taxpayer did not introduce any evidence showing how it had computed the addition to its bad debt reserve for the year at issue. Due to this lack of evidence, the Board of Tax Appeals sustained the Commissioner's calculation of the reserve based on a six-year average of the taxpayer's bad debt chargeoffs. Under those circumstances, the use of the formula was reasonable.

It is clear from its opinion that the Board did not intend the formula to be used as a *per se* rule, or even as a customary standard, of what is a reasonable addition to a bad debt reserve. It declared, 41 B. T. A. at 304:

> "The test, however, is whether the amount ultimately determined, regardless of formula, constitutes a reasonable addition to petitioner's reserve. *What constitutes a reasonable addition will depend upon the facts and circumstances of the business* engaged in with relation to general business conditions. A method or formula that produces a reasonable addition to a bad debt reserve in one year, or a series of years, may be entirely out of tune with the circumstances of the year involved." (Emphasis added.)

As recently as 1976, the Commissioner recognized that the *Black Motor* formula cannot be applied on an automatic basis. In Revenue Ruling 76-362, 1976-2 C. B. 45, 46, the Commissioner announced:

> ". . . [I]f the taxpayer can demonstrate that an amount greater than the amount determined under the *Black Motor* formula is reasonable, in light of the facts existing at the close of the taxable year, the taxpayer may compute the greater amount to be added to the reserve for bad debts."

In reaching that conclusion, the Ruling cited with approval the Tax Court's decision in *Westchester Development Co.*, 63 T. C. 198 (1974), *acq.*, 1975-2 C. B. 2, discussed at p. 79, *infra.*

This limitation on the use of the *Black Motor* formula is well founded because the formula is inherently arbitrary. It has built-in lags if the taxpayer's sales are increasing, if his bad debt chargeoffs are rising, if the average age of his receivables are lengthening, but most importantly, if he delays making chargeoffs. The inaccuracy of the formula is leveraged if the year-end balance of the taxpayer's accounts receivable is larger or smaller than normal. These defects are thoroughly analyzed in Whitman, Gilbert & Picotte, *The Black Motor bad debt formula: Why it doesn't work and how to adjust it,* 35 J. of Taxation 366 (1971).

The primary objection to the formula is that it cannot take into account special circumstances which entitle a taxpayer to a larger addition than his average bad debt experience would permit.* If a single customer of Thor went bankrupt owing it $184,000, there would be no question that Thor should be entitled to a larger than average addition to its bad debt reserve for the year. Yet that is inherently no different than the fact that at the end of 1965 Thor had several customers owing it $184,000 from whom it could not collect.

The formula is also subject to taxpayer manipulation. If Thor had been attempting to minimize its taxes in 1965, it would have charged off the $184,000 of hardcore uncollectibles. This would have increased its loss ratio to 3.763%. Applied to Thor's receivables at the end of that year according to the formula, it would have entitled Thor to a "reasonable" *addition* to its reserve of $269,723 as compared with the $136,150 addition it actually sought to deduct. Thor could have justified the $136,150 addition under the formula by writing off about $65,000 of the uncollectible accounts.**

* This is why the accounting experts testified that the *Black Motor* formula does not conform to generally accepted accounting principles. See pp. 16-17 *supra.* The S. E. C. is similarly concerned with inadequate bad debt reserves. See fn. at p. 59.

** Such chargeoffs do not require a "forgiveness" of the debt.

It becomes apparent that the *Black Motor* formula, which *directly* depends on the amount of debts charged off by the taxpayer, is contrary to the clear Congressional intention expressed in the companion subsection 166(a) governing the deductibility of wholly worthless bad debts by a taxpayer who has not elected the reserve method. After years of controversy, § 166(a) was amended by the Revenue Act of 1942 to permit a taxpayer to deduct a wholly worthless bad debt in the year it became worthless, regardless whether or not it had been charged off on the taxpayer's books.*

For these reasons, the use of the *Black Motor* formula should not be extended beyond the situation where it first arose—*i.e.*, where the taxpayer cannot demonstrate how he calculated his reserve for bad debts or where his calculation is not sound. Where, as in this case, the taxpayer demonstrates a careful and thoughtful review of the accounts by personnel familiar with them, and subsequent review by three additional levels of company management, *the accuracy of which is not questioned by the Commissioner*, this Court should not endorse the Commissioner's rigid insistence upon a questionable, if not arbitrary, formula.

C. The Commissioner Must, in Exercising His Discretion Under § 166(c), Take Into Account Current Data on Collectibility of the Taxpayer's Receivables

Although § 166(c) has been construed to give the Commissioner discretion in determining what is a reasonable addition to a bad debt reserve, *e.g.*, *Malone & Hyde, Inc.* v. *United States*, 568 F. 2d 474, 477 (6th Cir. 1978); *Patterson* v. *Pizitz,*

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* See § 23(k)(1) of the 1939 Code, the predecessor to § 166(a), as amended by § 124 of the Revenue Act of 1942, 56 Stat. 798, 820-21 (1942). See H. R. Rep. No. 2333, 77th Cong., 2d Sess. 76 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 89-90 (1942); *Revenue Act of 1942: Hearings Before the Comm. on Finance, United States Senate, on H. R. 7378*, 77th Cong., 2d Sess. 51, 692-93, 1612-13 (1942).

Inc., 353 F. 2d 267, 268-70 (5th Cir. 1965), *cert. denied*, 383 U. S. 910 (1966), the courts have not permitted the Commissioner to entirely ignore current facts and circumstances in favor of the taxpayer's chargeoff history, but consistently have found such an approach to be an abuse of discretion.

In *Calavo, Inc.* v. *Commissioner*, 304 F. 2d 650 (9th Cir. 1962), *reversing and remanding* 19 T. C. M. (CCH) 1359, P-H TC Mem. Dec. 60-1507 (1960), the Ninth Circuit held that the Commissioner had abused his discretion by failing to consider specific data on the probable uncollectibility of one of the taxpayer's accounts due from a debtor in financial difficulties. The Court of Appeals stated, *id.* at 654:

> "It is clear that debts may not be charged off against the reserve until they have become worthless. It does not follow, however, that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to reserve. Since the reserve normally is dealing with unknown factors bearing upon unidentifiable accounts, its reasonable extent is ordinarily calculated by resort to past experience with such accounts in the composite. But the fact that experience is the guide in dealing with unknown factors and unidentifiable accounts *should not require us to reject the more accurate guidance of known factors bearing upon identifiable accounts when such information is available. The extent of a reasonable reserve should depend upon an adjustment between known circumstances and experience.*" (Emphasis added.)

In its remand, the Ninth Circuit directed the Tax Court to resubmit the question to the Commissioner ". . . for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to [the] reserve." *Id.* at 655.*

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* The Ninth Circuit later distinguished *Calavo* in *United States* v. *Haskel Engineering & Supply Co.*, 380 F. 2d 786 (9th Cir. 1967),

(Footnote continued on next page.)

Calavo was followed by the Sixth Circuit in *Travis* v. *Commissioner,* 406 F. 2d 987, 991-92 (6th Cir. 1969). There the Commissioner refused to permit an addition to a bad debt reserve for uncollectible receivables arising from a dance studio's renegotiation of contracts with its customers. The Sixth Circuit held that this failure to consider current facts relating to the collectibility of the accounts made the Commissioner's calculation of the reserve "unrealistic and 'clearly erroneous.'" *Id.* at 991.

Rhode Island Hospital Trust Co. v. *Commissioner.,* 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927), was decided prior to *Black Motor,* but it involved a similar failure by the Commissioner to exercise his discretion in light of current facts. The Commissioner disallowed additions to the taxpayer's reserve for bad debts totalling $287,500, of which $200,000 was based on the taxpayer's appraisal of current deteriorating economic conditions in New England where it operated its small loan business, and of which another $87,500 was attributable to notes of a debtor in receivership. The First Circuit remanded the case for a determination, in light of the particular facts, of the amount which should be added to the taxpayer's reserve, declaring, 29 F. 2d at 341:

> ". . . if the Commissioner and the Board of Tax Appeals exercised their discretion, on legal and reasonable grounds, this court could not substitute its discretionary judgment for that of the tax authorities. But if there was failure really to exercise discretion, or error of law in its exercise, then the court must grant relief."

In each of these decisions by the First, Sixth and Ninth Circuits, the Commissioner was found to have abused his discre-

(Footnote continued from preceding page.)
rev'g 66-1 U. S. Tax Cas. 85,499, 17 Am. Fed. Tax R. 2d 861 (S. D. Cal. 1966), seemingly on the ground that the Commissioner had reviewed the factors urged by the taxpayer and had properly elected to ignore them.

tion because he failed to consider current data on collectibility.* This is exactly the situation in the instant case, where the rigid use of the six-year chargeoff average ignores the taxpayer's careful determination that some $184,000 of long-overdue accounts were uncollectible, representing 80.4% of the entire reserve required at the end of 1965 (Ex. 18, A38, A222).

In *Westchester Development Co.,* 63 T. C. 198 (1974), *acq.,* 1975-2 C. B. 2, in which the Commissioner acquiesced and cited as authority in Revenue Ruling 76-362, *supra,* pp. 74-75, the Tax Court found that application of the *Black Motor* formula was an abuse of discretion where the six-year period was unrepresentative of the taxpayer's current situation, stating 63 T. C. at 212:

> "The formula used by respondent will produce a satisfactory result where a *relative consistency* has emerged *in the pattern of the taxpayer's bad debt losses.* Reason compels us to conclude that petitioner's fiscal years ended February 29, 1968, and February 28, 1969, would prove *a wholly unrepresentative period in the history of petitioner's bad debt losses;* for petitioner's debtors were for the most part thinly capitalized corporations, the principal source of whose working capital was construction loans. Under the circumstances obtaining in this instance, we find respondent's attempt to apply the formula hereinabove described to have been wholly unwarranted and an abuse of discretion." (Emphasis added.)

* To the same effect see *Norfolk Industrial Loan Ass'n* v. *United States,* 70-2 U. S. Tax Cas. 84,251, 84,257, 26 Am. Fed. Tax R.2d 70-5296, 70-5303 (E. D. Va. 1970). The Commissioner was found to have abused his discretion by refusing to take into account the fact that many of the plaintiff's loans were delinquent more than 90 days. In that case, the reserve claimed by the taxpayer represented 75% of its accounts 90 days past due; Thor's entire reserve represented less than 40% of its accounts more than 90 days past due (Ex. 18, A38, A222).

See also *Richardson* v. *United States,* 330 F. Supp. 102 (S. D. Tex. 1971); *Gold-Pak Meat Co., Inc.,* 30 T. C. M.(CCH) 337, P-H TC Mem. Dec. 71-357 (1971); *Duffey* v. *Lethert,* 63-1 U. S. Tax Cas. 88,182, 11 Am. Fed. Tax R.2d 1317 (D. Minn. 1963).

During the period 1960 through 1963, Thor's accounts receivable increased 26.1%, while sales rose only 8.5%. The chargeoffs by prior management during this same period dropped from 10% of Thor's receivables balance in 1960 to 0.8% in 1963 (Ex. 6-F). These trends are consistent with the undisputed evidence that Thor's management prior to 1964 had overvalued its assets (A50), and vividly shows how "wholly unrepresentative" was the historical data upon which the *Black Motor* formula is based in this case.

* * *

The Commissioner's use of the *Black Motor* formula in the instant case thus did not comply with the statutory requirement that he exercise his discretion to determine a "reasonable" addition to the taxpayer's bad debt reserve, because that formula ignored all current data on the collectibility of Thor's accounts, contrary to the requirement of the Treasury Regulations.

CONCLUSION

The fact that the Court of Appeals sustained the action of the Commissioner on both the inventory and bad debt issues not only produces incongruous results, but also highlights the necessity for this Court to make clear that the Commissioner does not have unfettered discretion to reject generally accepted accounting principles in administering the Code.

In valuing its excess inventory, Thor primarily utilized a formula based directly on historical sales data to objectively value 44,000 different items of inventory which could not practically be valued on an item-by-item basis. Notwithstanding the fact that Thor's procedures were in accordance with generally accepted accounting principles and constituted the best accounting practice, the Court of Appeals held that the Commissioner did not abuse his discretion in determining *without explanation* that those procedures did not clearly reflect Thor's income. Conversely, although Thor evaluated its accounts receivable by an item-by-item analysis, the Court of Appeals held that the Commissioner did not abuse his discretion by requiring *without explanation* Thor to value these accounts by a formula based on Thor's 6-year history of bad debt chargeoffs.

In effect, the Seventh Circuit accorded the Commissioner virtually unlimited discretion to disregard generally accepted accounting principles as to Thor's inventory and bad debt valuation procedures. Nothing in the statutory language or its history suggests that Congress, when it enacted sections 446, 471 and 166(c) of the Code, intended the Commissioner to have such broad authority on an *ad hoc* basis, independent of any objective standards, to impose his own view of "proper" accounting on taxpayers whose accounting procedures unequivocally comply

with generally accepted accounting principles, are the best accounting practice in their trade or business, and are not inconsistent with the applicable Treasury Regulations.

Thor acknowledges that the objectives of these sections of the Code require a discretion in the Commissioner to deal with highly variegated factual situations, changing accounting practices, and potential overreaching by a small percentage of taxpayers. It submits, however, that in this instance the discretion has been extended to such extent that there are no objective standard at all. This is alien to a Government dedicated to laws rather than to decrees. It is unsound policy in that it undermines taxpayer morale in a self-assessment system that requires a deeply rooted feeling by taxpayers that they are being treated reasonably and fairly.

* * *

For the foregoing reasons, Thor respectfully requests this Court to reverse the judgment of the Court of Appeals on both the inventory and bad debt issues.

Respectfully submitted,

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